

**California Commission on Tax Policy
in the New Economy**

Sacramento
February 3, 2002

Proceedings

FEBRUARY 3, 2003: SACRAMENTO

Summary of Governor Davis' Remarks

Selected Quotes From Governor Davis

Honorable Gray Davis - California Governor

Taxes Can Preserve Our Quality Of Life

Summary of Feb. 3 Presentation

Steve Levy - Director, Center for the Continuing Study of the California Economy

Silicon Valley Innovation And The California Economy

Doug Henton - President, Collaborative Economics

California Economic Forecast

Tom Lieser - Senior Economist, UCLA Anderson Forecast

Testimony

Howard Roth, Ph.D. - Chief Economist, California Department of Finance

Revenues Expected From Various Tax Rates on 25 Selected Services

Revenues Expected From Various Tax Rates on 36 Selected Services

State Sales & Use Tax (SUT) Breakdown

Budget Revenue Enhancement Proposals, 2003 - 2004

Honorable John Dutra - California State Assembly Member

Honorable Jackie Goldberg - California State Assembly Member

Speakers

Steve Peace - Director, California Department of Finance

Tal Finney - Director, Governor's Office of Planning and Research

Clark Kelso, Ph.D. - California Chief Information Officer

Honorable Herb Wesson - Speaker, California State Assembly

Honorable Gilbert Cedillo - California State Senator

Honorable Dick Ackerman - California State Senator

CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY

California State Capitol Building
Senate Room 112
Sacramento, CA 95814
February 3, 2003
FINAL AGENDA

- 9:30 AM Chairman Rosendahl
Meeting called to order
Roll Call and Introductions
- 9:40 AM Steve Peace, Director, California Department of Finance
- 10:00 AM Tal Finney, Director, Governor's Office of Planning and Research
- 10:30 AM Howard Roth, Chief Economist, California Department of Finance
- 11:00 AM Break for Lunch
- 12:15 PM Commission Business
Approval of meeting minutes from November 19, 2002
Approval of working group assignments
Setting meeting dates for 2003
- 12:30 Honorable Jackie Goldberg – California State Assembly Member
Honorable John Dutra – California State Assembly Member
- 1:15 PM Tom Lieser, Senior Economist (California), UCLA Anderson Forecast
- 2:00 PM Steve Levy, Director, Center for the Continuing Study of the California Economy
- 2:30 PM Doug Henton, President, Collaborative Economics
- 3:00 PM Public Commentary
- 3:15 PM Chairman Rosendahl
Concluding Remarks
Adjournment

Note: Governor Gray Davis is tentatively scheduled to appear sometime early in the afternoon. Agendas for public bodies supported by the California Technology, Trade and Commerce Agency, are available at <http://commerce.ca.gov>. The Commission also maintains a website at www.caneweeconomy.ca.gov. For additional information regarding this notice, please contact Marshall Graves, California Technology, Trade and Commerce Agency, 1102 Q Street, Suite 6000, Sacramento, CA, 95814, (916) 445-7654, mgraves@commerce.ca.gov

MEETING MINUTES
California Commission on Tax Policy in the New Economy

California State Capitol, Senate Room 112

February 3, 2003

9:30 A.M.

Commissioners Present:

- William J. Rosendahl, Chairman
- Marilyn C. Brewer
- Sean O. Burton
- Lawrence Carr
- William Dombrowski
- Lenny Goldberg
- Scott Peters
- Glen Rossman
- William Weintraub

Ex-Officio Members Present:

- Gerald Goldberg (Executive Officer, Franchise Tax Board)

Ex-Officio Members Representatives Present:

- Bob Affleck for Michael Bernick (Director, Employment Development Department)
- Marcy Jo Mandel for the Honorable Steve Westly (State Controller)
- Connie Squires for Tim Gage (Director, Department of Finance)
- Nick Vucinich for the Honorable Gilbert Cedillo (Chair, Senate Committee on Revenue and Taxation)

Call to Order

WELCOMING REMARKS AND INTRODUCTIONS

Chairman Rosendahl introduced the Commissioners and welcomed everyone to the first meeting of 2003 and the seventh meeting overall. He recapped the Commission's work in 2002 (about forty presentations were made) in light of the following concepts:

- What people are thinking and what needs to get done.
- How do we ensure a fair process in the new economy?
- How do we deal with economic benefits of the dot-com industry?

Remarks by Steve Peace

Director, California Department of Finance

Mr. Peace indicated his desire to provide reliable and independent information to the Commission and to raise the level of discussion on permanent structural reform. Major points he discussed were:

- Volatility of revenue stream and the over reliance on high-end taxpayers.
- Proportion of income paid in taxes by the poorest in California is higher than the proportion of income paid in taxes by the richest in California.

Relationship between the State and local government is a residual of Prop 13. It creates an environment in which local government does not have the independent status and capacity to respond to the changes in the economy and demand of its local citizenry because it is dependant on the State for its revenue. As long as we have that circumstance, every time we have an environment such as we have today, local government is at risk.

A government that works the best is that which is generally closest to the people, where the services are delivered

We are a major donor state to the federal government. National economy in free fall. Massive deficits at federal and state levels.

Two states New Mexico and Wyoming do not have deficits - natural gas - they are balancing their state budgets on our money, our businesses, and ratepayers have paid in gargantuan natural gas and electricity prices.

Our government delegations need to adopt a bi-partisan agenda to advocate for California. Their needs to be more thought about operating government as a business and not as a philosophic enterprise and recognize the dangers of differences of opinions.

We no longer have three to five years to deal with this because of the national economy performance. We can barrow our way out. At what price? Pay ten percent interest in a four percent market. Folks in the political world, that people in the financial world, don't look favorably upon political polarization.

The State of California has a great reputation as being financial experts in government.

If consumers slow down or stop. If growth in real estate refinance slows, disposable income from refinance will evaporate.

Key points:

- Capital gain takes a while.
- If we have credibility to short-term plan, must have a belief that California is on path for reassessment between taxpayers and local and federal governments and state - local relationships.
- We can piece by piece rebuild a tax structure within the context of a new economy. Currently it's so screwed up, that most any idea would be better than what we have now,
- Look at deductibility for federal taxes to restore a balance with federal government.

What we need to do:

- Look at totality of taxes vs. individual taxes.
- Make things simple.
- Efficiency is not the exclusive goal. California must accept some inefficiency in order to build a structure that works with human beings.
- Machines and software can't replace human decisions and concepts of fairness and equity.

Mistakes will be made

Mathematicians have developed models for economists that will

Commerce and markets depend on human emotion and irrationality.

Stability of social structure

Critical to an economy

There's no doubt of the seriousness of the budget numbers. The Governor's numbers are good, but they don't take into consideration the possibility of an economic slowdown.

Numbers are prudent and cry out for structural reform. Great opportunity. Problem is too big for any individual or government agency. It's a problem that every person from every capacity of life can solve together.

Chairman Rosendahl: Commission charter is to examine four major elements of the state's tax structure within the context of the new economy

1. Sales and Taxes
2. Telecommunication Taxes and Fees
3. Income Taxes
4. Property Taxes

We hope that this accident of fate provides an opportunity for us to help you all to come up with a fair and right solution to it all.

Commissioner Goldberg: Government Consensus Project who made some structural reform recommendations, but possibly due to not having the crisis structural, like the current crisis upon us, the effort generated a lot of interesting ideas but it ultimately failed on bringing structural reform.

Do you have a clear sense of process and focus for all of us or is it the Governor's leadership that will do that?

Peace Answer: A lot of time and effort has already brought about some good ideas and information. There is no need to create more Commission's, as the issues are well understood. No more time should be spent on the identifying problems. Next should be looking at what works, then looking at how to sell it. Hopefully California's collective interest will drive parties back together. The Governor intends to lead the process to bring the ideas together and factor non-partisan cooperation.

Commissioner Goldberg: Where and how is this process going to happen How will he bring us together?

Peace Answer: That decision is to be made by the Governor. DOF needs to make the State work as a business. The Governor has submitted a fiscal plan that could work.

DOF will support the decisions of the policy makers and will make it work.

How to make structural change. Have to overhaul the sooner the better, but DOF is not a decision maker. People may be disappointed in my new perspective. Elected officials

are the fundamental basis of our democracy. Elected officials are right and must be considered as being right.

Commissioner Rossman: Is it a spending problem or a revenue problem . Why are we so much in the hole?

Peace Answer: Republicans and Democrats significantly and enthusiastically increased expenditures in education. Democrats - pushed for expenditures in healthcare and Republicans - pushed for expenditures in the form of tax relief.

With a twenty-six billion shortfall, education, healthcare and tax relief equate to about seven or eight billion out of twenty-six billion. If all state programs were eliminated and only local government and schools were funded we'd still be short. Old and young populations' pressures are driving social service requirements.

Commissioner Burton: Why has the economy changed and what is new about the economy?

Peace Answer: There is a new economy because of technology. Sales tax rooted in brick and mortar. Sales tax doesn't have a place in a modern economy. The underground economy is growing. What wouldn't it take to replace sales tax with a flat rate income tax? More progressive. Sales tax not deductible in federal taxes.

Flat income tax that if looked at individually would be criticised, as not being adequately progressive, but if looked at in the context of the overall tax structure, would actually result in a progressive tax structure.

Commissioner Weintraub: Structural changes alluded to structural changes that are required. This year the Commission must deliver a final report, realistically. Will there be structural tax change proposals or any structural changes implemented within the lifetime of this Commission and do you see the need for an external pressure point to push for structural change that can not occur through the normal role of government.

Peace Answer: There will be proposals submitted to the voters, but it will be dependent upon how proposals are presented to the voters. Too many proposals presented to voters will not work. We can't muck it up with a lot of changes. Believes businesses would be willing to pay more commercial property tax, if there were some capital gain relief. The damage of Prop 13 needs to be addressed.

Commissioner Weintraub: What is the time frame?

Peace Answer: Proposals must be ready for the March ballot in 2004.

Chairman Rosendahl: What kind of revenues can the State generate from commercial property and how would business react?

Peace Answer: Didn't want to get into the specifics respond. Governor has been careful to convene the dialogue and letting everyone know that he's open to all ideas. Combined effect of California not having preferential capital gain treatment discourages buying and selling of property. Property held in families longer than necessary because inflation portion of increased property values are not accounted for.

Commissioner Brewer: I don't hear anyone talking about cutting down government expense. Government has grown by thirty-seven percent during the Governor's first term.

Peace Answer: All three major components of budget are actually smaller than they previous were. Governor has been in office. Not in education. Next health care than tax relief.

Commissioner Brewer: How do we get better since we are told we aren't doing enough?

Peace Answer: Healthcare and mobility is of great concern. Employer's healthcare plans don't work so well with employees changing companies too often. Different viewpoints from Republicans and Democrats, specifically when it involves providing health insurance to children.

If the budget doesn't include statutory authority to make changes, the only area the Governors has blue pencil authority is in higher education at a time when enrollments are at historic highs. Have to lock-up legislature without cameras or media and come together.

Commissioner Rossman: As it relates to structural changes, how much access does DOF have on demographics change. What does the future look like?
It is

Peace Answer: Potential future for California may result in less educated workforce with lower incomes. As baby boomers getting ready to retire, the potential for mass migration of middle class Californians to moving to places where it's cheaper to live. Solutions are not easy, the various legitimate issues pale when you get down to the core issue which is that we don't have the infrastructure in place so we don't get the yield off of the private sector portion of the investment to be able to support the underline infrastructure.

Failed to keep infrastructure and manufacturing Systematic exportation of jobs out of the country. High tech manufacturing and intellectual property were seeing all those jobs

migrate overseas. Governor wants to continue manufacturing investments credits. We've already lost way too many manufacturing investments. Not only do we need to protect it, but we need to bring it back. Both in Great Britain and in England deteriorated rapidly because they stopped producing.

Chairman Rosendahl: Introduced Tal Finney, Director of Office Planning and Research. Clark Kelso, California's Chief of Information Officer responsible for all Information Officer

Speaker Finney: Reviews Dr. Jeffrey Cole's, report put out by the UCLA Center for Communication to the up with Policy, "Surveying the Digital Future," dated 2/1/03. The third year in a three-year report surveys Internet users in California, United States and worldwide. Dr. Jeffrey Cole is the Founder of the World Internet Project.

Surveying the Digital Future - Report Highlights

The top five uses of Internet in 2002 were:

- E-mail and Instant Messaging
- Web Surfing and Browsing
- Reading News.
- On-line Shopping
- Accessing Entertainment Information.

A three years study shows that Internet access spans every age range.

Number hours per week increased:

Eleven point one (11.1) hours per week per user in 2002.
Nine point eight (9.8) hours per week per user in 2001.
Nine point four (9.4) hours per week per user in 2000.

New Internet users in 2002 were online an average of 5.5 hours per week
Use of Internet at home in 2002 increased to 59.3 percent of Internet users.

Reportedly there's been a dramatic increase in broadband.

More than one fourth (1/4) of households have computers.

More than ten percent have three or more computers working at home.

Internet Purchasing Behavior

The dollar value of Internet purchasing increasing. As people become comfortable, they stop shopping in stores.

On-line buying is likely to increase.

Credit card security major issues - Ninety percent of users worry about hackers, too many unknowns.

Forty-six percent of folks thought it would be a problem if Internet sales were taxed.

Focusing on projects in state to use IT to change how we do things.

Ongoing Projects:

- US System to network with all education levels Internet II level.
- Demographic study to layer data for decision makers.

Speaker Kelso: New economy. NASA's space program will continue.

Extemporaneously

California has played a leading role in technology entertainments, aerospace, computers, biotechnology new economy

California has western spirit of adventure and innovation. We must become and maintain leadership in science and technology.

Competitions exist all over the world. Business community doesn't always have a long-term outlook. Government may have to strike right balance for healthy climate to spear growth and support citizens. Congratulations to Commission on interim report.

Chairman Rosendahl : Interim Report on line at www.caneweeconomy.ca.gov
<<http://www.caneweeconomy.ca.gov>> Number of citizens using accessing government exceeds access for e-commerce.

A day or a rooted in the up to

How do you feel about taxing the Internet?

Not directly involved. Not a tax expert.

Speaker Finney: If tax scheme addresses the Internet, it would change worldwide dynamics. Major changes and increase in Internet for e-government. More businesses services info

Commissioner Rossman: How does the State rate on e-commerce. Are we doing the right thing? Believes the State is behind on networking infrastructuring.

Finney Answer: Compared to large industries, the State is behind, but ahead of other governments. Competitive drive in economy requires winners and losers. Mostly reads about successes. Government better off trailing behind to be able to pick the winning technologies.

Extremely complex to develop a roadmap in business. Does the State of California Does California have a roadmap?

Answer: No. No strategic plan. Hinders ability to move forward. New IT governance legislation will do that.

Speaker Finney: Kelso brought in for that. We'll see dramatic paradigm shift. Physics Professor in Northridge teaching high school physics in Redding is huge homeland security. George Vincent how a use technology to assist.

Technology will achieve savings - allow government to maximize promise technology brings.

Commissioner Carr: Is it still fair to characterize Internet and e-commerce as "a new and emerging process?"

Answer: Yes - continuing increased in number of new users. Experienced users expanding use.

Speaker Kelso Answer: Still maturing in the sense that there is still a level of distrust. Business models still evolving for e-commerce.

Growing use of Internet and what's proper roll for revenue programs for mail order and Internet sales. Government should be careful of favoritism. Economy is successful because it is market driven. Government intervention would distort efficiencies.

Internet sales - very small in overall economy. Dot-com crash still left forty thousand jobs and successful companies. We need to deal with issues now not later.

Speaker Finney offered his staff and his office as a resource for the Commission.

Speaker Howard Roth, Chief economist with the Department of Finance.

He begins by stating a few personal observations about the new economy and tax policy. He believes that the tax policies need to be thoroughly re-evaluated in times of major structural economic change or technological change and suspects the failure to do so, in the past, has led to some serious problems in the California economy today.

He also believes the downsizing of the aerospace of the California aerospace in the late 1980s and in the first half of the 1990s as an example, of major structural economic change. He considers broadening of available means of the delivery of television programming and Internet services to households in the wake of deregulation of the telecommunications industry as an example technological change.

Questions that need to be asked when such changes occur is:

1. All the existing tax structural continue to meet our revenue needs?
2. Are the same products and services taxed differently depending on the way they are delivered for accessed?
3. Will the economic or technological change make existing tax structures more regressive or more progressive

The consolidation of the nation's aerospace industry a decade ago resulted in the closure of many facilities in California. Hundreds of thousands of good paying jobs were eliminated or moved outside the State. Rockwell International, McDonnell Douglas,

General Dynamics and other large employers disappeared or merged into other aerospace companies, most the time out of the State. This downsizing and the coincident national recession led to sharp declines in State tax revenues and large budget shortfalls in the early 1990s that are now being compared with the current large budget shortfall.

In solving the large budget deficits of a decade ago the State used its powers to reallocate local property taxes, raise revenues and cut spending. However, no fundamental restructuring of the tax system occurred in the early 1990s. The more recent broadening of delivery choices for television and Internet services has raised questions about whether providers of the same service, using different technologies for delivery are treated equitably under existing tax policy. One of the presenters at the San Diego forum argued that cable providers of television programming and Internet services are taxed more heavily, in this case by local governments, than more recently establish satellite providers. As technology allows new or existing firms to offer services in different ways it is important to assess whether new providers enjoy a competitive advantage stemming from favorable tax treatment or alternatively or unduly burdened by existing tax policy.

This is who is standing in the middle of a long-standing debate that has been rekindled by the growing use of the Internet.

What is the proper tax treatment on consumer purchases of tangible goods through the mail or now through to the Internet?

It is hard to collect to taxes or used taxes on Internet and mail ordered purchases. Yet it is unfair that a high percentage of these sales escape taxation when sales taxes are collected on the vast majority of sales by brick and mortar sellers. Also to the extent that untaxed mail order and Internet sales replace brick and mortar sales. Tax revenues are reduced and the tax base narrowed. It is tempting to try to protect infant industries offering new goods and services or existing goods and services delivered in alternative ways. Certainly they should be protected from unfair competition from existing companies but absent that the government should be careful about favoring specific industries. Either by out right subsidy or by allowing an unfair tax advantage to persist.

The primary reason the U.S. economy has produced so abundantly for so long, Is that it's a market-based economy. New ideas and products and services have to prove their metal in the market. Those they can't, fail. It may sound harsh but at this trial by fire is necessary to ensure the efficient allocation of resources that makes the U.S. economy so exceptional.

For the government to favor in industry is to risk resources being wasted on industry that otherwise would not make the cut.

It is also unwise to observe that the Internet and catalog retail sales are relatively small and conclude that we should not be so concerned about a tax advantage that these companies may enjoy.

Admittedly there are a lot fewer dot COM firms today than two years ago this is evident in the state employment statistics. The number of jobs in information retrieval services which includes dot COM retailers fell from 89,400 from September 2000 to 38,100 in June 2002. A drop of 57 percent.

In assessing the staggering loss we need to remember that venture capitalists and investment banks nurtured and promoted many firms with questionable business plans and fueled a frenzy for these firms shares when taking them public. When the illusion was finally revealed funding dried up for most of these firms.

Setting off the dot COM crashes still there remained nearly 40,000 job and information retrieval services in California today and about a dozen or so dot columns are reporting profits despite the weak economy. There is a place for these firms perhaps it's more of a

Speaker Roth . . . continued

niche now but convinced that they will grow in number in the coming years. It's better to determine their tax treatment now than to wait.

In this regard, I recommend that the commission to a close look at the pros and cons of California's joining the Streamline sales tax project. The multi-state collaboration looking at among other things how to level the tax-planning field. Between brick and mortar retailers and Internet and catalog retailers.

Now speaking more generally, as you observed, Mr. Chairman, in your letter to the governor accompanying the commissions interim report the commission might usefully performed a valuable public service by delving in broader range of tax revenue issues and offering what sound recommendations it can. Now that the downturn in the State's high tech sector has exposed an inheretent weaknesses in the States tax structure.

As the state has struggled to solved big projected budget shortfalls in the last two years, it has frequently been claimed that the state relies too heavily on a very small number of high income tax payers for a big share of its tax rev in the summary of the governor's recently released budget revenues. And that as a result, state tax revenues have become very volitable. This could be the case, in the summary of the governor's recently released budget, points out for example that the top 11 percent of state taxpayers, those with adjusted gross incomes of over \$100,000 reported 53.7 percent of total income and paid 79.5 percent of the personal income in the tax year 2000.

Certainly state tax revenues have turned on the fortunes of the state's highest income residents a in the last five or six years. In evaluating whether the state's personal income tax is too progressive however, we need to remember the last five or six years were anything but normal. The rapid run up of stock prices particularly tech stock prices was the primary reason to the top 11 percent of the states taxpayers paid such an extraordinary high percentage of taxes in a tax year 2000.

The productivity of the state income

1. Volatile revenues in Reserve fund
2. Require sunset review
3. Balance portfolio to receive
4. Balance portfolio off local government revenues. Fiscal-ization of land use. Retail stores and auto malls exacerbates housing and transportation issues.
5. State's fiscal structure outdated.

Commissioner Dombrowski: SSTP user taxes how to collect user taxes. What is the most recent data on user taxes?

Answer: Nothing new

Commissioner Rossman: There is a user tax but not enforced. What is the roadblock?

Answer: Trying to get info from other states.

Comment: How do you pay user tax as a citizen?

Question: With increased DOD spending on war on terror. Will aerospace come back? Other changes?

Answer 1. Increased benefits from security spending. Southern California Aerospace firms will benefit.

Answer 2. California relying more on exports to Mexico and Asia than other states.

Answer 3. Personal income has become much more difficult to predict because of stock options in to have the high tech firms. Drop of income was almost severe as ninety's recession.

Commissioner Goldberg: Question of extreme volatility, why fighting the last war caused retail and real estate purchases in decline?

Answer: Consumers not spending as much. Will be okay if housing prices only plateau. Consumer confidence declining. Possibility of war with Iraq affecting confidence.

Will high tech jobs come back if economy gets better? Some question whether jobs will come back.

Evidence is slim - risk to outlook

Commissioner Weintraub: Loss of jobs and structural problem. Is loss of jobs anyway attributable to tax and regulations policies?

Answer: Hard to quantify. Some have expanded in other states or move to somewhere else in state. Suspect bark is worse than bite, but it is a concern but difficult to discern.

Commissioner Rossman: Is the data for 2001 not yet available?

Answer: Connie Squires - DOF obtains data from FTB. Data has not yet been analyzed.

12:05 pm - Adjourn for lunch

12:40 pm - Reconvene

John Dutra, Assembly Member provided chart - budget revenue enhancement proposals.

12:45 pm **Jackie Goldberg**, Assembly Member arrives.

Chairman Rosendahl: How much could we get back from Bush's tax cut?

Answer: Maybe one third of thirty billion of donor outflow to federal government cited by Peace.

Commissioner Peters: Income tax - do you see any equity issues?

Jackie Goldberg, Assembly Member **Answer:** Looking at taxing services. Huge gains in revenue. Prop 13 great distortions. Don't want to rely on capital gains. Nine billion dollar drop.

Dutra, Assembly Member: Will get chart from Elizabeth Hill - one time spike of capital gains.

Charts and graphs provided to Commissioners.

Jackie Goldberg, Assembly Member - If we continue to have fiscal policy determined by initiative chaos, such as Schwarzenegger initiative now must devote half a billion to after school programs. If we get better system, what can we do to protect it. To keep it from being under taxing of services. Top twenty-five huge amounts of revenues could potentially be available and would provide a more stable system.

Commissioner Rossman: Any benchmarking with other states that tax services?

Answer: There are about seven states. Will obtain and provide data to the Commission. Split roll a problem. Maybe to set a recurrent time for reassessment. It wouldn't be a solution for short term. Triple net lease insurance, maintenance, property taxes. If ratio continues to go to residential side, turnover about every five to six years.

Commissioner Rossman: Commercial property in Santa Clara County has deflated but there hasn't been any reassessments so businesses are being over taxed.

Response: Split roll wasn't the cause in the decrease of taxes. Businesses asking for adjustments and reassessments.

Commissioner Peters: Any doubt a constitutional amendment would be required?

Answer: No.

1:26 pm: **Ed Chavez, Chair Assembly Revenue and Tax:** Welcomed Commission and thanked Commission for their hard work. He offered staff assistance to Commission.

1:33 pm: **Tom Lieser, UCLA Anderson Forecast** - Provided notes.

Chairman Rosendahl: Should government have incentives to create more housing as an infrastructure develop.

Answer: Long debate over role of government. Public money may have crowded out private money in the past. Anything to support pilot project or incentives would be good. LA County rent structure still under some controls because of doubling up.

Commissioner Goldberg: Leaner pointed out uniqueness of internal bubble. Any other periods like that. Doesn't want to fight only on twice in a century problem. We are so tied to national economy we can't get well on our own.

Answer 1. Many provisions of the federal package would be good for long term capital development but not for short term stimulus and doesn't adequately address problem of state and local government which will be a drag on national economy.

Answer 2. Uniqueness of high tech, but similar to Dept. of Defense strategic arms build-up. Difference is we'll keep the foundation for digital technology.

Commissioner Burton: Do you feel fundamental characteristics of the new economy changed, or are we coming back full circle?

Answer: We still have the best engine for innovative entrepreneurship and high tech growth.

Commissioner Rossman: Would like to look at 03 though 13. Charts (?) are looking back. Schools aren't turning out high skills. Welcomes views.

Answer: Studies showed pronounced differences between regions. Most like (---?) to Bay Area was a college graduate. Southern California (---?) was less than high school - reflected by less in aerospace.

Speaker Levy: Reference our interim report. New economy needs government services. Demands of new economy always point to expanded government services - all studies on economic studies. We'll need additional tax revenues, not rate hikes.

Number one and two issues on every list from business where we are failing are infrastructure and education. In last four years, we have increased public spending. Did that improve economic competitiveness? Fortieth to 33rd I spending per capita on K-12.

Tax policy decisions (?) about economy come down to what is the competitiveness.

Another issue struggling with is sales tax. An Old Economy tax. Will not keep pace.

Regarding Proposition 13, agrees with Commissioner Goldberg. Must make local government a full partner with property tax. May be able to loosen rules to allow revenues to keep pace with economic growth. Look for changes in income tax and services.

Commissioner Peters: What is proper way to deal with state/local relations.....how to incentives local governments?

Answer: The local governments are willing to invest in their own regions.

Commissioner Peters: What about constitutional protection for local governments?

Answer: Want flexibility for local governments to (---?) revenues to need.

Commissioner Goldberg: We must invest in infrastructure. Local government's over-reliance on big box and state on income tax. How to reform property tax? What incentives for housing? Fees into price of housing?

Answer 1. Progressive income tax is good.

Answer 2. Want sales tax to grow.

Answer 3. Would like to hear property tax reform. Homeowners could probably deal with three to four percent cap, versus a two percent cap.

Answer 4. In (----?) of supporting local housing choices to back off on fees.

Speaker Henton: The New Economy in the Silicon Valley is separate phases of innovation, all followed by recession.

Get a copy of the study.

Does the tax structure support the economy? Does it broaden the base?

Speaker Wesson: Welcome, hope John Dutra shared (?). Keep "trucking" on.

Governor Davis: Appreciate the hard work. Over the past 25 years, California has been faced with volatile revenues. To balance the budget - hard choices. Structural reform has the most promise. Absolutely essential. Would like another interim report by late April. Open to new ideas Include in the May Revise work of the Commission as part and parcel of the budget. If there is money available to disperse, it will be dispersed of. But that depends greatly on the performance of high wage earners - when there is a downturn, we do poorly. Any suggestion to (----?) off peaks and valleys. There should also be some sort of reserve fund to be capped at the same level. Variety of one-time uses.

For the second part of structural reform, other revenue sources besides income tax. Shave off capital gains from income taxes. Try to dampen the cycles.

Will ensure that the commission's efforts will not be in vain. Will not sign a budget without structural reform.

Chairman Rosendahl: Comments regarding the Internet?

Answer: At some point, transactions should be subject to sales tax. Try to stay in sync with the federal government.

Commissioner Goldberg: Regarding process, how do we get people to the table to grapple through this? All the stakeholders.

Answer: It's an enormous challenge. At the end of the day, we must have a two-thirds vote. Full range from ideal to what is possible. Would be a tragedy to miss the opportunity. People are willing to do the extra during crises.

Commissioner Peters: Comment - speaking for local governments, appreciate leadership for structural reform.

Commissioner Weintraub: Problems caused over many, many years.....what are your thoughts?

Answer: Don't often get an opportunity to make a change to benefit generations to come.

Commissioner Rossman: The commission is willing to vigor into the process, but the commission is unfunded.

Answer: If ever there is a time when citizens respond, this is it. We don't have all the resources we need. Most states have similar problems. Can't promise resources. Would be happy to write a letter to a budget committee. Will have this info with us.

Commissioner Brewer: We need something to help us.

Answer: Freeing up some staff resources in OPR to help.

3:08 pm Speaker Henton returned.

Senator Cedillo: Point of view from the Revenue and Tax Committee. We have a monumental budget crisis. Very constructive bipartisan effort in this committee.

We need to (---?) keenly aware we are the fifth largest economy in the world. Richest state in the richest country. We have resources.

We want stability - how to harness our values. How do we keep our major companies competitive?

Looks at value of Internet.

Commission Business

Chairman Rosendahl stepped out; Commissioner Burton assumed the Chair.

Motion to adopt the minutes of the previous meeting. Moved by Commissioner Peters, seconded by

Commissioner Drombowski: Second motion.

Approved unanimously.

Working Group Discussion:

Commissioner Peters: Do we have time for a report?

(----?) Answer: Netted (?) evaluate taxes we have and evaluate Joint Venture. Glen will take action item to solicit....Commissioner wants conference calls to think it out.

Commissioner Peters: We need analysis from Joint Venture.

Commissioner Brewer: Overwhelmed...take one or two things and do a good job.

Chairman Rosendahl: Governor looking for easy revenue enhancements. If circumstances are so desperate, maybe we can do something dramatic.

Commissioner Burton: Believe the Governor is serious about structural change.

Commissioner Drombowski: Don't reinvent the wheel.

Commissioner Carr: Not too far off.

Commissioner Burton: What do we want to do?

Commissioner Peters: Can we do conference calls?

Commissioner Brewer: Focus on property and sales tax.

Commissioner Drombowski: Don't.

Commissioner Rossman: What do these taxes do to competitiveness and job creation.

(Bill Rosendahl returned at 3:56 pm)

Chairman Rosendahl: We need take a deep breath and take a look at dynamics. Challenge is ours. Suggest a conference call. Make a significant outreach to Republicans. Put on desk of every member.... we'll pick a date that works.

Commissioner Peters: Governor invited us to be bold.....go for it.

Chairman Rosendahl: The next meeting will be in Sacramento on February 24, 9:30 am to 1:30 pm, same room.

Commissioner Burton: Wants(?) group meetings afterwards.

Chairman Rosendahl: Conference call next week, Friday, February 12, 5:00 pm to 6:00 pm.

Chairman Rosendahl: Goldberg: We need conference calls for working groups.

Senator Ackerman: Doesn't have any thoughts on how to balance the budget without tax increases.

Chairman Rosendahl: Come back and give us your thoughts later.

Commissioner Peters: February 24 - start at 8:30 am. General consensus, motion to approve. Proposed working groups. Commissioner Goldberg volunteered to also participate in telecom(?)/income(?) tax.

Chairman Rosendahl: Solicited comments from the public. No comments were made.

Commissioner Burton: Motion to adjourn.

Commissioner Brewer: Seconded Motion.

Approved unanimously.

The meeting adjourned at 4:21 pm.

Summary of Governor Davis' Remarks at the Commission on Taxation in the New Economy, February 3, 2003

By Martha Jones, Ph.D., California Research Bureau

California has volatile sources of tax revenue. To fix the current shortfall, everyone has to contribute. Most importantly, structural reform of our tax system is necessary. He reiterated that he would not sign any budget without structural reform.

The Governor asked the Commission to make a report to him before the end of April, so its recommendations can be considered in the May Revision. He would like the report to include the Commission's recommendations for structural tax reform. He emphasized that he is open to new ideas and wants to hear new ideas.

One thing Governor Davis has learned from his years in Sacramento is that any funds available in Sacramento will be disposed of. With extra funds, Democrats tend to increase spending on programs and Republicans tend to fund tax relief. The tendency to spend what's available is a bi-partisan one.

California's primary revenue source is the income tax. Because this tax is highly progressive, we end up depending on high-income taxpayers for the bulk of our revenues. The volatility of high-income earnings, however, translates into volatility of tax revenues.

We need to make our revenue stream more stable. Governor Davis made two proposals:

1. **SPENDING RESTRAINT:** In order to restrain spending in the good times (when income tax revenues are above trend), he suggested a mandatory reserve and/or a spending cap. (He made it quite clear he was not recommending or proposing, any particular options, but was just throwing these ideas out for consideration.) The size of the reserve would be limited by a trigger mechanism. To prevent the fund from growing too large, one-time projects would be funded when the reserve size hits the trigger.
2. **OTHER VOLATILE REVENUE SOURCES:** Perhaps capital gains should be funneled into a different fund, not the General Fund. These would be for one-time expenditures.

Responding to a question, Governor Davis said he feels that Internet transactions should be taxed eventually, but the question is when? He felt like the industry should be established first before being taxed. At present, California should move in tandem with the federal government on this issue. (This was a vague answer. One could infer that he thinks the industry is established and ripe for taxation. One could also infer that he would be ok with the Streamlined Sales tax because it provides for national or close to national taxation even though the federal government is not pushing for it.)

**Selected Quotes from Governor Gray Davis before the
California Commission on Tax Policy in the New Economy**

February 3, 2003

“Thank you for taking on this very important task. Your work product will be significant to us because of the gravity of the situation that we’re faced with.”

“Any suggestions you have.....would be very much appreciated.”

“This is a very challenging problem before you. I very much welcome your suggestions.”

“Thank you for your hard work and I assure you your efforts will not be in vain.....we will take them very seriously.”

“It would be a tragedy to miss the moment.”

“You don’t often get an opportunity to make change that will benefit Californians for generations. This is such an opportunity.”

“I always valued citizen participation in politics. If there was ever a time for people to do the best they can with modest resources, this is the year.”

“I’d be happy to write a letter commending your efforts, for whatever value that is.”

“If we have information we’re happy to provide it to you. Feel free to call upon the Director of Finance and.....that information is available to you.”

“My staff is trying to free up some people in the Office of Planning and Research.....to give you some additional staff resources.”

“The Little Hoover Commission has lasted a long time. Maybe the Rosendahl Commission can now be the new whatever you care to call yourself in the report and can make even a greater impact in the years to come.”

“Thank you for your sustained commitment to this project.”

CENTER FOR CONTINUING STUDY OF THE CALIFORNIA ECONOMY

610 UNIVERSITY AVENUE • PALO ALTO • CALIFORNIA • 94301

TELEPHONE: (650) 321-8550

FAX: (650) 321-5451

DATE: January 31, 2003

TO: California Commission on Tax Policy in the New Economy

FROM: Stephen Levy

SUBJECT: Summary of Feb 3 Presentation

1. Changes in the structure of the California economy **do** have implications for the state budget and for local government budgets as well. My recommendation for the Commission is to think about both the revenue and expenditure side of the budget when asking what changes should be made to reflect the “new economy”. To the extent that there is a “new economy”, it will change the spending priorities to maintain economic competitiveness as well as change the yield of various taxes.
2. Economists do not often use the “new economy” language, but economists **do** discuss changes in the structure of the economy. The “new economy” can refer to:
 - a) Changes in worker/employer relationships—the idea of contingent employment
 - b) Changes in benefit packages
 - c) Changes in the amount of training provided by private employers.
 - d) Changes in the amount of economic activity that deals with “information” and requires higher skill levels
3. The long-term trend for sales tax revenues is a decline in the rate of growth relative to the rate of growth in the economy. As the economy has moved toward services representing a greater share of spending, the sales tax applies to a smaller share of total economic activity.

The response to this trend can be to broaden the sales tax base to include fast-growing service components. The purpose would be to allow sales tax revenue growth to keep pace with overall economic growth.

The sales tax is critical in financing local government and transit districts as well as a major component of state revenue, so the long-term decline in the growth rate does pose a threat to overall revenue growth.

4. The Commission should expect that the rate of growth in demand for public spending and investment will outpace the rate of growth of the economy. The direct implication is that there will be upward pressure on tax rates and sources as public budgets strive to keep up with the demands of the “new economy”

The simplest way to see this is to ask what are the competitive factors essential to attracting “new economy” industries and firms. Our research and the research of others in California points to investment in education, transportation (and other infrastructure) and quality of life as the key to the state’s economic competitiveness. Why would a firm be attracted to the state if our education, infrastructure and quality of life are not among the nation’s best.

Yet, despite great efforts by the Governor and legislature to boost investment in these areas, California remains below average in investment in education and infrastructure.

It is simply not possible to boost our competitive position in these key investment areas without additional tax revenue.

5. Another “new economy” tax policy issue is how to provide a stream of revenue that gives local governments the incentives and revenues to provide for adequate housing, infrastructure and world-class public services.

Some ideas worthy of consideration in this regard are broadening the sales tax base, revising the property tax “take” by revising the assessed valuation “rules” relative to commercial property (to increase the growth in related revenues) and to consider increasing the allowable increase in residential AV beyond the current 2% per year limit.

6. The fundamental question facing the Commission and the state’s residents is whether the increase in public investment and health and child care for low-income families begun since 1998 is important to the state. If these investments are important to our economy and quality of life (I believe that they **are**), then the state will need additional revenue to fund them, whether or not the stock market-related income rebounds or not.

Taxes Can Preserve Our Quality of Life

(Op-Ed Commentary, L.A. Times, January 14, 2003)

By Stephen Levy

Gov. Gray Davis finally has proposed a budget that focuses attention on serious choices about state taxes and spending.

First, we need to agree on what happened during the last four years and stop the partisan blame game. A good economy and soaring stock market allowed the state to increase education spending by \$10 billion a year, put additional funds into transportation investments and broaden health care and child care for low- and middle-income families.

In addition, tax cuts of nearly \$7 billion a year on car licenses and business income were adopted.

Now, stock market-related taxes have fallen by \$10 billion and the economy is weak. There is some blame for both political parties for avoiding the hard budget choices last summer when solutions would have been easier. This time, we need to solve the problem.

We need to stop posturing and agree that tax increases are reasonable as part of the budget solution. Past spending supported critical economic, quality-of-life and equity goals, and a tax increase to minimize cuts in these programs is a wise investment in our future. Despite recent spending increases, we are still below average in per-pupil spending and per capita investment in transportation. Moreover, local governments are under extreme fiscal pressure and we are not producing enough housing.

California cannot compete for new firms and jobs unless we are willing to invest in high-quality public institutions and infrastructure. Moreover, these investments improve the quality of life for Californians.

The tax increases should be temporary, not permanent. The \$35-billion deficit estimate is probably too high, the economy should do better than the governor assumes, and permanent tax increases should be debated with much better information than we have now.

A temporary increase in taxes and fees of about \$10 billion a year would represent less than 1% of the total annual income of all residents and repeat the successful bipartisan and balanced budget package of a decade ago.

Low- and middle-income families should be protected as much as possible. The demand for health-care and social service spending goes up in bad economic times, yet this spending will be cut severely even with tax increases.

The proposed income tax surcharge on families with incomes of more than \$250,000 should be part of a fair budget solution. In addition, the cuts in vehicle license fees should

be repealed temporarily as the law allows; we no longer can afford them.

The governor's proposed sales tax increase, however, is a poor choice as either a replacement for lost stock market- related taxes or a foundation for long-term fiscal reform. The sales tax is a relatively slow-growing revenue source and falls more heavily on low-income families.

A sales tax increase does not meet the governor's goal of adjusting to changes in how the economy operates and would compete directly with using sales taxes to finance local transportation improvements.

Broadening the sales tax base to include services would capture some high-growth areas of the economy (particularly if we were to capture all Internet sales) and is an idea worthy of consideration as a new permanent revenue source.

Long-term fiscal reform must include adequate revenue for local governments and strong incentives for housing. The governor's proposal does neither, although his idea of realigning services and revenues for local governments has merit.

Meeting the governor's objectives requires reform in property tax collection, including raising the assessed valuation of property but not raising property tax rates.

Finally, I support the governor's call for President Bush to give federal aid to states. How can we be serious about economic stimulus if we allow state and local governments to lay off teachers, cancel construction projects and decrease cash payments to poor families? A federal aid package of \$50 billion to \$100 billion would give \$5 billion to \$10 billion to California and avoid the most devastating layoffs and cuts.

The specifics of the governor's budget will change as the Legislature gets involved, but the key questions will not. Education and infrastructure spending were good investments when stock option income paid for them. They are still good investments even if we have to pay more taxes for a while.

Slide 1

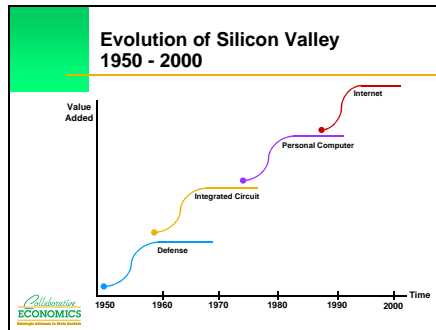
Silicon Valley:

**The Innovation Region
and
The California Economy
and Tax Structure**

Doug Henton
President
Collaborative Economics

*Collaborative
ECONOMICS*
Economic Strategy for the Future

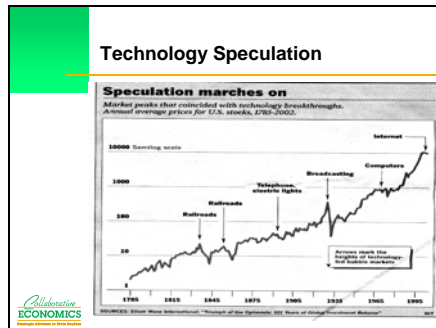
Slide 2



There have been at least four major technology waves that have shaped Silicon Valley since World War II. Each wave has built innovation networks of talent, suppliers, and financial service providers that have helped make the next technology wave possible.

The four waves are:
Defense
Integrated Circuit
Personal Computer
Internet

Slide 3



Slide 4

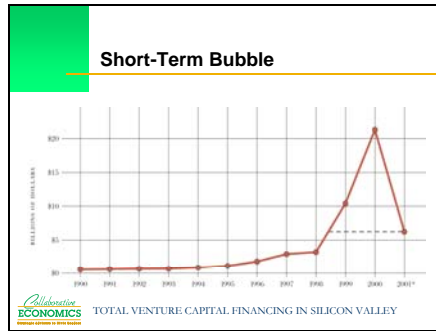
**The Valley from Schumpeter's
Perspective**

- ◆ Economies are driven by dynamic waves of innovation
- ◆ Entrepreneurs take advantage of opportunities
- ◆ "Swarms" of new firms cluster around talent and technology

*Collaborative
ECONOMICS*
Economic Strategy for the Future

Joseph Schumpeter outlined a dynamic framework for understanding innovation:
Economies are driven by dynamic waves of innovation
Entrepreneurs take advantage of opportunities
"Swarms" of new firms cluster around talent and technology
The evolution of Silicon Valley can be viewed in a Schumpeterian perspective of technology waves.

Slide 5



Media: Bubble; Economists: Hype Cycle

Technologic advance, entrepreneurs and investors swarm, imitator, drive up returns to crazy level, and CRASH.

We can see the extent of the Internet Hype Cycle through investment in venture capital.

Reached \$20 billion. Drove up salaries and office space. In year 2000, 22% salary increase, office space \$2-\$5. People flocked in.

Entirely predictable. One study last year found that 133 dot-com companies would have had to grow by 80% for 5 years to justify their market valuations. Clearly, unsustainable.

This cycle is over. Not much we can do about this. Stop mourning the past, learn from it. Focus on the future. Promise ourselves we'll keep perspective next time.

Each time waves surge and recede, job growth contracts or stalls. We experienced significant job growth, followed by job losses, in the 1970s, 1980s, and early 1990s.

Prompted by **external shocks** (defense spending/contraction, Japanese competition), as well as **technological advances** (commercialization of the integrated circuit, invention of the Web browser.)

New technologies transformed existing industries and created new industries. There were new opportunities and requirements, and our region adapted.

Why? Because of our special habitat (culture, specialized infrastructure)

Have two fundamental advantages over other regions.

Despite current slow-down, one reason the **long-term outlook remains good** is our productivity advantage.

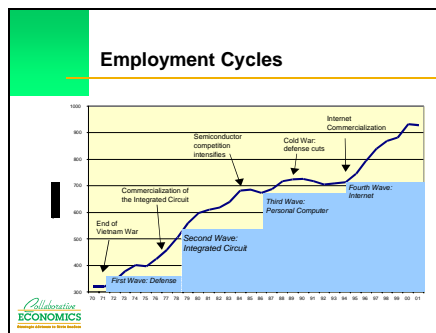
What Matters Most for the Long-Term. The rate at which an economy increases its productivity **determines** the speed at which it can improve its standard of living. Productivity increases allows business to produce a) **higher quality goods**, or more goods, at lower costs. Can pass this on to customers, workers, and owners without causing inflation. **"Working Smarter"**

How much smarter. McKinsey: output per capita in Bay Area is 84% higher than U.S. Average. The Index shows 100% for Silicon Valley.

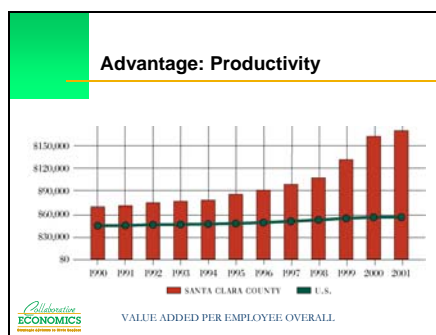
Across **all sectors**!

Why: "Habitat"
Application of technology
High-concentration of leading-edge businesses
Clusters of highly skilled workers
Culture of innovation.

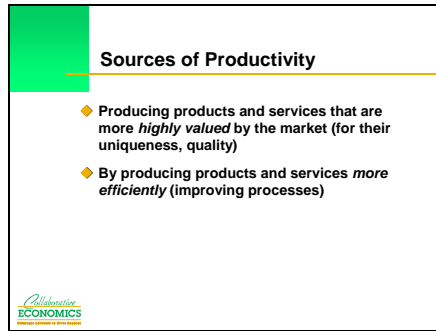
Slide 6



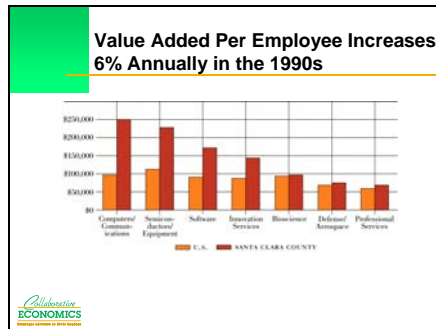
Slide 7



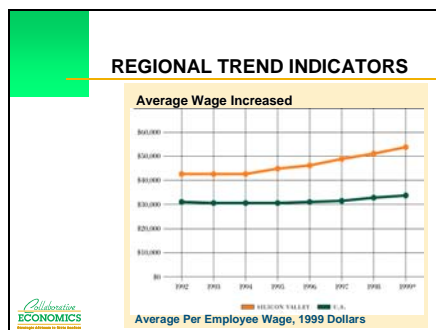
Slide 8



Slide 9



Slide 10



Silicon Valley's successive waves of innovation have stimulated the rapid evolution of industry. Industry clusters are concentrations of competing, complementary and interdependent firms and industries that create wealth in regions through export to other regions.

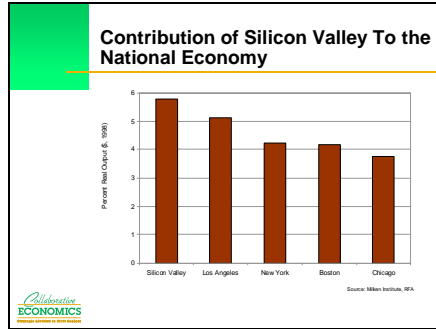
Geography is important to clusters because of what firms and people gain from being in the same place. The ease and speed of sharing a specialized workforce, suppliers and networks are enhanced by close proximity. This proximity helps to reduce "transaction costs" that are critical to the success of fast-moving firms.

Silicon Valley is a prototypical cluster-based economy. Building on its formal and informal networks, industry clusters in the Valley grow because they benefit from sharing talent, technology and financial resources based in the region. Because of this clustering, Valley firms exhibit high productivity measured by the value-added per worker.

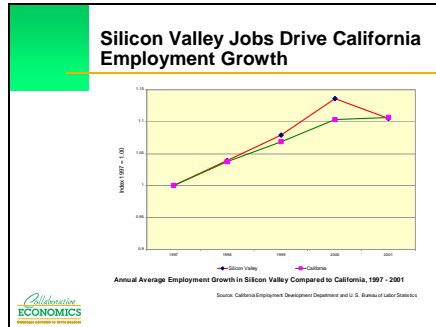
This high productivity is a major reason why the average wage rates in the Valley are 50% higher than the nation. It also explains how Valley firms can prosper in an environment of high labor and land costs. With high productivity and low transaction costs due to cluster economies, Valley firms can pay higher wages and still be profitable. This result turns traditional economic development theory on its head--the model that firms will seek the lowest cost environment no longer works in the high-value new economy where a premium is placed on access to skills and technology. Location based on talent and proximity to other firms matters.

The growing Internet economy in Silicon Valley is built on this new value-added development model. a survey of Internet firms in Silicon Valley found that Internet companies gravitate to locations with "access to a talented pool of employees, proximity to core (non-Internet) businesses, established infrastructure, access to capital and presence of quality educational and research institutions." In that survey, talent and proximity to core businesses ranked as the highest factors.

Slide 11



Slide 12



Slide 13

Why Innovation is Key

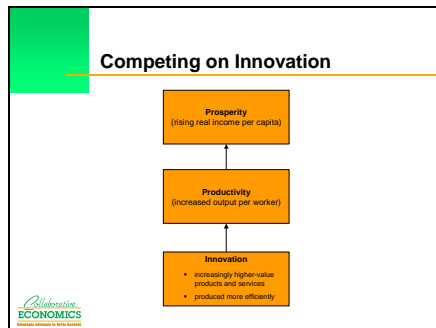
- ◆ Innovation is the key to success in today's economy.
- ◆ Continuous reinvention is required to keep pace with the rapid pace of change.
- ◆ The basis of increasing productivity is innovation.
- ◆ Productivity is the basis for prosperity.

The key to understanding innovation is the power of networks that allow individual entrepreneurs to connect in new ways. In a seeming paradox, successful entrepreneurs today requires an innovative, collaborative region. The days of the lone inventor (Edison) and monolithic corporation (GM) are over. The era of the networks has arrived.

Productivity growth is the basis for rising real wages for workers, increasing returns to shareholders, and increasing per capita income for a region and the nation.

The basis for increasing productivity is innovation. In the long term, an advanced economy like that of the United States cannot compete by just lowering costs or increasing inputs. the only way to compete and raise our standard of living is to find new and better ways to use natural, human, and capital resources to increase productivity.

Slide 14



Slide 15

What is Innovation

- ◆ The purposeful search for changes and the opportunities that such changes might offer.
- ◆ Entrepreneurs innovate—innovation and entrepreneurship go together.
- ◆ Innovation occurs within
 - Firms
 - Industry
 - Regions

Collaborative ECONOMICS

What is innovation? Literally, it is the act of making changes. It involves introducing new ideas and new ways of doing things.

Peter Drucker defines innovation as the purposeful ...

Innovation can lead to a series of incremental improvements, and it can also lead to radical change.

Drucker maintains that innovation and entrepreneurship go together. Entrepreneurs innovate, and innovation is the specific instrument of entrepreneurship. Drucker says also, The entrepreneur always searches for change, responds to it and exploits it as an opportunity.

Drucker, like Schumpeter, sees innovation and entrepreneurship as the engines of change in the economy. They are the source of wealth creation and the generator of opportunity for individuals and society.

Slide 16

Innovation ≠ High Tech

- ◆ There are no high tech or low tech industries anymore—just innovative or non-innovative companies.
- ◆ Innovation is important in any industry.
- ◆ What matters is how you compete, not what you make.

Collaborative ECONOMICS

Slide 17

Innovation Critical in All Industries

- ◆ **Agriculture**—e.g., genetics, improved farming practices, better storage raising productivity
- ◆ **Forest Products**—e.g., engineered products, use of wider range of species transforming product content and mix
- ◆ **Manufacturing**—e.g., internet transforming B2B relationships, customer service
- ◆ **Creative Services**—e.g., technology change blurring traditional craft distinctions; local suppliers collaborate, share capacity

Collaborative ECONOMICS

Slide 18

The Next Economy?

The diagram illustrates the progression of economic eras. It starts with the 'Resource-Based Economy' at the bottom left, moves to the 'Technology-driven Economy' in the middle, and finally reaches the 'Innovation-Led Economy' at the top right. A wavy line connects these three stages, suggesting a continuous and evolving process.

Collaborative ECONOMICS

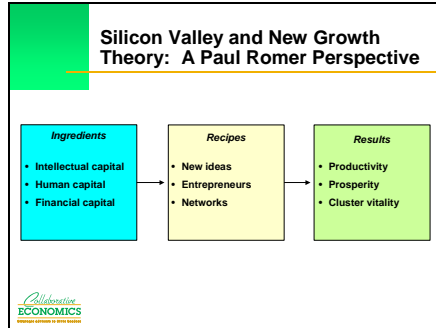
Slide 19

New Growth Theory and Innovation

- ◆ Paul Romer says ideas are the primary source of economic growth.
- ◆ “Recipes (new ideas) combine ingredients (resources) in new and different ways to yield more valuable economic results.”
- ◆ The recipes come from the innovation process.

Collaborative ECONOMICS
Innovation • Growth • Opportunity

Slide 20



Silicon Valley’s success as an innovation region relies on networks of personal communication and practical trial and error learning rather than on the formal application of research.

Silicon Valley has moved from one wave on innovation to another because of its deep innovation relationships built on personal relationships among entrepreneurs, venture capitalists, university faculty, accountants, lawyers and marketing experts. The constant interaction and reconfiguring of these relationships are the essence of Silicon Valley’s network economy. Stanford economist Paul Romer has developed a “new growth theory” that provides a way to understand the central role of innovation in advanced economies. In new growth theory, ideas are the primary catalyst for economic growth. New ideas generate growth by reorganizing physical goods in more efficient and productive ways. For Romer, the ingredients (the physical items) are not as important as the recipes (the ideas).

Recipes (new ideas) combine ingredients (natural, human, capital resources) in new and different ways to yield more valuable economic results. The recipes come from the innovation process.

Regions need to understand what conditions support the generation of new ideas and the translation of existing ingredients into high-value outcomes.

Slide 21

Shifting Industries


| | |
|-------------------|-------------|
| Low cost | Knowledge |
| Quantity | Quality |
| Stability | Speed |
| Capital equipment | Flexibility |
| Control | Networks |

Collaborative ECONOMICS
Innovation • Growth • Opportunity

Slide 22

Innovation is a Social Process

- ◆ Interactive—doesn't occur in a straight line.
- ◆ Group creativity—not dependent on a few.
- ◆ Tacit knowledge—depends on "know-how."
- ◆ Networks—ideas flow more freely.
- ◆ Competition/collaboration—both are needed.



Interactive: it doesn't occur in a straight line, chain link fashion from research lab to development to commercialization.

Group activity: innovation results from the creative process and this creative process occurs in groups. every person has the promise of being creative, and this promise can be unleashed as groups of people share and shape their insights through a creative process. It is a dangerous myth to view innovation as dependent on a handful of especially creative individuals.

Tacit knowledge: based on personal experience. Theoretical or explicitly knowledge establishes a base of information for innovators. But it is the know-how gained through personal experience and learning by doing that leads to innovation (the Knowledge-Creating Company)

Networks: in the new economy, ideas flow more freely within networks. The unit of innovation has become the network, not simply the firm. To stay abreast of change and speed up the commercialization process, the walls that once separated public and private institutions, education and business, large and small firms must come down.

Competition/Collaboration: Co-opetition, means that individuals and companies can compete ferociously, but collaborate at the same time to create knowledge. ie, Linux programmers, Java programmers, community of professionals

The networks at the heart of the new innovation model function most effectively when their components are clustered geographically in a region.

The most innovative work occurs primarily in face-to-face exchange within teams where people work in close proximity to each other.

Although electronic communication is important, it is not a substitute for the trust, sharing, and intense interpersonal interaction essential for the innovation process.

For this reason, the creative heart and soul of the economy will continue to be tied to place. Ultimately place matters, because people matter. Talented and creative people want to be where the action is, where their ideas stand the best chance of coming to fruition. Because they compete on time to market, it is not accidental that Internet companies start and grow in the geographic pockets that share these critical characteristics:

- strong, diverse talent pool
- pillar companies in high tech
- risk tolerant venture capital and angel investors
- specialized support services
- universities
- entrepreneurial community


In her path breaking research comparing Silicon Valley and Boston's Route 128, UC Berkeley planning professor, Anna Lee Saxenian found that the performance difference between the two technology regions was the network model in Silicon Valley that connected companies and sped up the innovation process. Route 128 had similar assets but different results because it failed to collaborate and build open networks for information sharing. According to Saxenian, the important part is not the ingredients as much is how the community leverages its assets. Francis Fukuyama summarized the importance of networks to innovation in Silicon Valley:

"The whole of Silicon Valley can be seen as a single

Slide 23

Innovation is Place Based


- ◆ Most innovative work occurs in face-to-face exchange within teams.
- ◆ Geographic clustering is a powerful mechanism for sharing personal knowledge.
- ◆ The creative heart and soul of the economy will continue to be tied to place.
- ◆ Location is still important.



Slide 24

The Innovation Process

- ◆ It's not the ingredients but the recipe.
- ◆ What matters most is the ability of entrepreneurs to connect regional assets and leverage them through the innovation process to achieve competitive results.



Slide 25



Slide 26



large network organization that can tap expertise and specialized skills unavailable to even the largest vertically integrated Japanese electronics groups and their keiretsu partners. The impersonal sharing of data over electronic networks is not enough to create the mutual trust and respect evident in Silicon Valley. What matters most is the ability of companies and entrepreneurs to connect with appropriate regional assets and leverage them through the innovative process to achieve competitive results.

What regional factors most affect the ability to speed up the translation of ideas into results?

Resources: human, technology R&D, investment capital, infrastructure

Process: Idea generation, commercialization, entrepreneurship, business/management innovation

Results: individual opportunity, competitiveness, business and cluster performance.

Build fundamental assets: education, research, financial platforms.

UC San Diego became the leading research university in UC system and one of nation's leading catalysts in helping create a regional technology economy. Two UC professors helped to stimulate both bioscience and digital communications industries in San Diego and model a culture of academic entrepreneurship.

Austin

Connect entrepreneurs and companies

San Diego and Pittsburgh

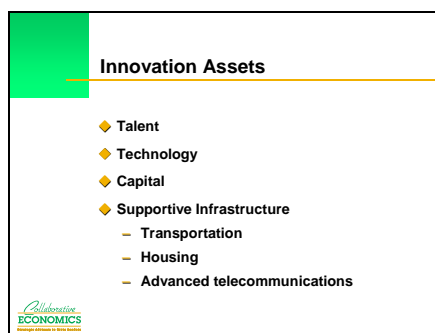
Promoting a Regional Culture of Innovation

Greater Washington, Pittsburgh and Massachusetts

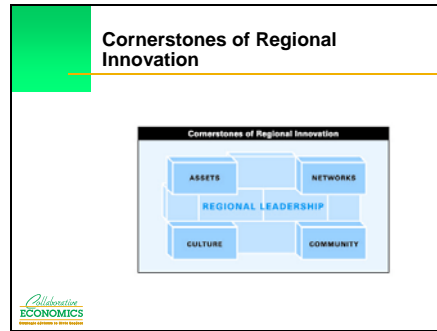
Make Quality of Life and Innovation Asset

Silicon Valley and other innovative regions: Austin, San Diego, Greater Washington, Cambridge

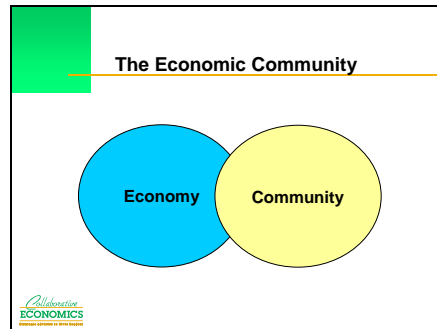
Slide 27



Slide 28



Slide 29



Slide 30

- ### The Innovation Economy Values
- ◆ Economic Regions
 - ◆ Distinctive Quality of Life
 - ◆ Vital Centers
 - ◆ Choice for Living and Working
 - ◆ Speed and Adaptability
 - ◆ The Natural Environment
- Collaborative ECONOMICS*
Economic Regions as Important Places

Slide 31

- ### Innovation Economy Values Economic Regions
- ◆ The shift to a new economy, and the changing nature of work, place a premium on regions as important places.
 - ◆ Geography is important to clusters because firms and people gain from being in the same place.
 - ◆ Clusters gain their power through the force of face-to-face creative collaboration.
- Collaborative ECONOMICS*
Economic Regions as Important Places

Slide 32

Innovation Economy Values Distinctive Quality of Life

- ◆ The new economy values quality of life more than the old economy, because it values people more than the old economy.
- ◆ Livability and quality concerns are only becoming more important with economic change.

Collaborative ECONOMICS

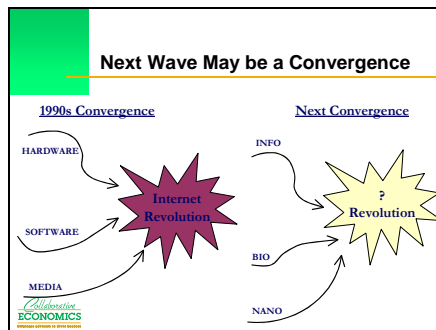
Slide 33

New Realities

1. Technology is a given
2. Globalism is here to stay
3. Knowledge builds wealth
4. There's no such thing as a smooth ride
5. Competition is relentless
6. Alliances are the way to get things done
7. People are the key to success
8. Place matters

Collaborative ECONOMICS

Slide 34



1990s we saw convergence...

Stan William, HP Laboratories:

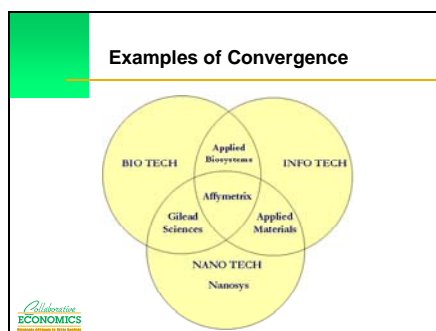
We are watching the birth and convergence of **three great new technologies**, all simultaneously.

All three of these areas are completing the transition from applied science into technology right now. And during the next 20 years, all three of these are going to see exponential types of increases, we'll see factors of 10,000 improvements in the capabilities of each of these.

Any of these areas by itself would be classified as an industrial revolution. But having all three of them progressing simultaneously, interacting and reinforcing each other is going to be completely beyond anything we've experienced.

We can't know exactly how this will play out, but clear potential to both create new industries/companies, but also transform many existing industries and companies.


Slide 35



Slide 36

Preparing for the Next Waves: State and Regional Responses


- ◆ Do leaders understand the opportunity?
- ◆ What must we do to ensure it happens here?
- ◆ What are the requirements?
- ◆ How can local people and communities benefit?
- ◆ Can we avoid some of the pitfalls of past waves?

 Building a Better Future

Slide 37

Key Points

- ◆ The bubble has broken, let's learn and **move on**.
- ◆ Goal: sustain habitat advantages in **productivity and innovation**.
- ◆ We can anticipate the next wave: **convergence**.
- ◆ Silicon Valley is well-positioned, but there is **no permanent franchise**.
- ◆ Must work together to ensure that next wave happens here, works for us.

 Building a Better Future

Your industry has been a critical part of every wave that has happened here, adapting and innovating.


No one has all the answers about what exactly will happen next and what we'll need to do to prepare....

You are in a unique position to Join the process, lead it. Good historical perspective, passion for Valley. Look out for your own direct interests, but also be regional stewards.

Slide 38

Tax Principles for an Innovative Economy


- ◆ Current tax structure is inadequate for the innovative economy
 - Boom/bust revenue cycles
 - Weak fiscal foundation
 - Does not promote growth economy
 - Continuing state-local conflicts over revenues and services

 Building a Better Future


Slide 39

Principles for Tax Structure

- ◆ Equity
- ◆ Stability
- ◆ Compliance
- ◆ Efficiency
- ◆ Growth
- ◆ Diversity
- ◆ Neutrality


 Building a Better Future

Slide 40




Some Economic Goals to Consider

- ◆ Does the tax structure encourage innovation?
- ◆ Does it avoid boom/bust cycles?
- ◆ Is the tax base broad with a “level playing field” for the both consumers and businesses?
- ◆ Are rates fair- based on “ability to pay” and “benefits received” ?




Slide 41



Tax Structure and Innovation Economy

- ◆ Now may be a time to consider fundamental tax reform to “fix” long term structural problems
- ◆ Broadening the tax base would allow for lower rates
- ◆ New and different combinations of taxes may need to be considered to promote innovation, fairness and create a sound fiscal foundation



California Commission on Tax Policy in the New Economy
Testimony by Howard Roth
California Department of Finance
February 3, 2003

Mr. Chairman, Commissioners, Representatives, thank you for giving me this opportunity to share my thoughts on tax policy today. I applaud the work you have done to date. I attended your public forum in San Diego last September and thought that it elicited a great exchange of ideas. I have read your interim report, which I think nicely lays out the issues before the commission. And I find it fitting, as well as helpful, that charged with examining the impact of the Internet and other forms of electronic technology on various forms of taxes, you have chosen to use that very technology to make your work more accessible to the public by posting it on a website.

I would like to begin by making a few observations about the new economy and tax policy.

I believe that tax policy needs to be thoroughly and carefully re-evaluated in times of major structural economic or technological change. I suspect that the failure to do so in the past has led to some serious problems in the California economy today.

I think of the downsizing of the state's aerospace industry in the late 1980s and the first half of the 1990s as an example of a major structural economic change. I consider the broadening of available means of delivery of television programming and Internet services to households in the wake of deregulation of telecommunications industry as an example of technological change.

Questions that need to be asked when such changes occur are: (1) Will the existing tax structure continue to meet our revenue needs? (2) Are the same products or services taxed differently depending on the way they are delivered or accessed? (3) Will the economic or technological change make the existing tax structure more regressive or progressive?

The consolidation of the nation's aerospace industry a decade ago resulted in the closure of many facilities in California. Hundreds of thousands of good-paying jobs were eliminated or moved outside the state. Rockwell International, McDonald Douglas, General Dynamics and other large employers disappeared—merged into other aerospace companies. This downsizing and the coincident national recession led to sharp declines in state tax revenues and large budget shortfalls in the early 1990s that are now being compared with the current large budget shortfall. In solving the large budget deficits a decade ago, the state used its powers to reallocate local property tax, raise revenues and cut state spending. However, no fundamental restructuring of the tax system occurred in the early 1990s.

The more recent broadening of delivery choices for television and Internet services has raised questions about whether providers of the same service using different technologies for delivery are treated equitably under existing tax policy. One of the presenters at the

San Diego forum argued that cable providers of television programming and Internet services are taxed more heavily, in this case, by local governments than more recently established satellite providers. As technology allows new or existing firms to offer services in a different way, it is important to assess whether new providers enjoy a competitive advantage stemming from more favorable tax treatment or, alternatively, are unduly burdened by existing tax policy.

This issue is at the center of a longstanding debate that has been rekindled by the growing use of the Internet: What is the proper tax treatment on consumer purchases of tangible goods through the mail or, now, over the Internet? It is hard to collect sales taxes or use taxes on Internet and mail order purchases. Yet, it is unfair that a high percentage of these sales escape taxation when sales taxes are collected on the vast majority of sales by brick and mortar sellers. Also, to the extent that untaxed mail order and Internet sales replace brick and mortar sales, tax revenues are lost and the tax base narrowed.

It is tempting to try to protect infant industries offering new goods and services or existing goods and services delivered in alternative ways. Certainly they should be protected from unfair competition from existing companies. But absent that, government should be careful about favoring specific industries, whether by outright subsidy or by allowing an unfair tax advantage to persist. A primary reason the US economy has produced so abundantly and efficiently for so long is that it is a market-based economy. New ideas, products, and services have to prove their mettle in the market. Those that can't, fail. It may sound harsh but this trial by fire is necessary to ensure the efficient allocation of resources that makes the US economy exceptional. For government to favor an industry is to risk resources being wasted on an industry that otherwise would not make the cut.

I also think it is unwise to observe that Internet and catalog retail sales are relatively small and conclude that we should not be concerned about any tax advantage these companies might enjoy. Admittedly, there are a lot fewer dot-com firms today than two years ago. This is evident in the state's employment statistics. The number of jobs in information retrieval services, which includes dot-com retailers, fell from 89,400 in September 2000 to 38,100 in June 2002—a drop of 57 percent. But, in assessing this staggering loss, we need to remember that venture capitalists and investment banks nurtured and promoted many firms with questionable business plans and fueled a frenzy for these firms' shares when taking them public. When the illusion was finally revealed, funding dried up for most of these firms, setting off the dot-com crash. Still, there remain nearly 40,000 jobs in information retrieval services in California, and a dozen or so dot-coms are reporting profits, despite the weak economy. There's a place for these firms—perhaps it's more of a niche right now—but they will likely grow in number in the coming years. Better to consider their tax treatment now than wait. In this regard, I recommend the Commission take a close look of that pro's and con's of California's joining the Streamlined Sales Tax Project—the multi-state collaboration looking at, among other things, how to level the tax playing field between brick-and-mortar retailers and Internet and catalog retailers.

I would like to talk more generally now. As you observed, Mr. Chairman, in your letter to the governor accompanying the Commission's interim report, the Commission might usefully perform a valuable public service by delving into a broader range of tax and revenue issues and offering whatever sound recommendations it can, now that the downturn in the state's high-tech sector has exposed inherent weaknesses in the state's tax structures.

As the state has struggled to solve big projected budget shortfalls in the last two years, it has frequently been claimed that the state relies too heavily on a very small number of high-income tax payers for a big share of its tax revenues and that, as a result, state tax revenues have become very volatile. This may well be the case. The Summary of the recently released Governor's Budget points out, for example, that the top 11 percent of state taxpayers—those with adjusted gross incomes of over \$100,000—reported 53.7 percent of the total income and paid 79.5 of the personal income tax in tax year 2000. Certainly state tax revenues have turned on the fortunes of the state's highest-income residents in the last five or six years. In evaluating whether the state's personal income tax is too progressive, however, we need to remember that the last five or six years were anything but normal. The rapid run-up of the stock prices, particularly tech stock prices, was the primary reason that the top 11 percent of state taxpayers paid such an extraordinarily high percentage of taxes in tax year 2000. The progressivity of the state's income tax amplified the effect of rising stock prices on tax revenues, of course, but the run-up in stock prices was key.

I do not expect to see another stock price bubble like that in my career. Past ones have come decades apart. It seems that such bubbles require the presence of a significant number of investors who have not experienced one before first-hand. My point is that in judging whether the state's income tax is too progressive and in need of fixing, we should not assume that high-income taxpayers will continue to pay such a high percentage of the state's taxes as they did in tax year 2000.

In thinking about the state's current budget problems, I wonder what was more responsible: a volatile tax structure or hasty decisions to spend more and cut taxes when tax revenues were stronger than expected. But I think it would be wise to consider reforms that promote better decisions when tax revenues are unexpectedly strong while at the same time examining whether state tax revenue is too volatile due to, perhaps, an unfair allocation of the tax burden.

In this regard, let me refer to some proposals for consideration regarding tax policy made in the Governor's Budget Summary as part of an appeal for reform of California's fiscal structure:

- Create a state budget reserve to mitigate the volatility of the state's revenues, and re-evaluate current spending limit requirements. Require that once the Special Fund for Economic Uncertainties has been established at the appropriate level, any proceeds from extraordinary revenue growth, particularly from volatile revenue sources, be placed in a reserve fund for one-time purposes.

- Require sunset review of all tax breaks. As with automatic spending laws, the existence of hundreds of tax breaks for businesses and individuals reduces moneys available for desired spending. These tax breaks often continue long after the rationale for their adoption has disappeared. Under this proposal, every tax expenditure currently authorized would sunset and be extended for the period of five years only after the effectiveness of the tax expenditure has been determined.
- Rebalance the portfolio of state revenue to achieve a more stable mix of major revenue sources—Dependence on more volatile revenue sources has hampered the state's ability to consistently meet funding demands in critical programs. The State needs to examine ways to more fairly allocate the tax burden and reduce revenue volatility.
- Rebalance the portfolio of local government revenue to achieve a better mix of major revenue sources, and encourage "rational growth" decisions. Acknowledge the fact that the current revenue structure virtually forces local governments to make unwise land use decisions. Known as the fiscalization of land use, this leads to intense competition between neighboring cities over the location of businesses. Local competition for retail stores or auto malls to generate sales tax revenue rarely balances community housing needs or the benefits of non-retail business and industry. The competition also exacerbates transportation and environmental problems. Property tax revisions, such as changing the manner in which commercial properties are re-assessed, might provide improved fiscal incentives for local governments to address local needs.

Mr. Chairman, Commissioners, the time is right for a thorough review of the state's fiscal system. The existing system is old and rickety, full of patches and repairs, some good, some not so good. It was built for a very different economy than the one we have today. Some changes to the system over time have resulted in unintended, undesired outcomes that continue to hurt the state economy.

Although your charge was more narrowly defined, I think the issues you will encounter are the same ones that would be important in a broader examination of the state's outdated fiscal structure. I hope your work gets us well on the way to a new and improved fiscal structure in California.


Thank you again for giving me this opportunity to share some of my thoughts with you today.

Slide 1

The UCLA Anderson School
California Economic Forecast

Tom Lieser
Senior Economist

February 3, 2003



Slide 2

U.S. Short-Term Forecast
December, 2002

| | <u>2001</u> | <u>2002</u> | <u>2003</u> | <u>2004</u> |
|-------------------------|-------------|-------------|-------------|-------------|
| Real GDP (% Ch.) | 0.3 | 2.4 | 2.5 | 3.5 |
| Consumer Spending | 2.5 | 3.1 | 1.6 | 2.2 |
| Business P&E | -5.2 | -5.6 | 0.7 | 8.0 |
| CPI Inflation (% Ch.) | 2.8 | 1.6 | 2.6 | 2.4 |
| Unempl. Rate (%) | 4.8 | 5.8 | 5.9 | 5.6 |
| Fed Funds Rate | 3.9 | 1.7 | 2.6 | 4.7 |
| Pre-Tax Profits (% Ch.) | -14.3 | -1.2 | 5.8 | 19.0 |



Slide 3

California at Year-End 2002

- ◆ Slow growth in South, slow decline in Bay Area.
- ◆ Home construction, sales, and prices: too strong?
Bay Area prices more than 3 times U.S. average.
- ◆ Nonresidential market is worsening statewide.
- ◆ IT sector: Global semichip sales up 25% in 2002, but increase was mainly overseas.
- ◆ International: exports worsened in 3rd quarter.
- ◆ Dec. unemployment rate at 6.6%, vs. 6.0% U.S.



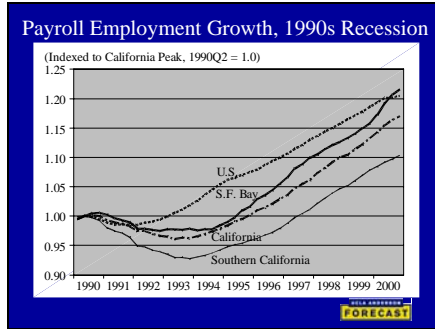
Slide 4

California Short-Term Forecast
December, 2002

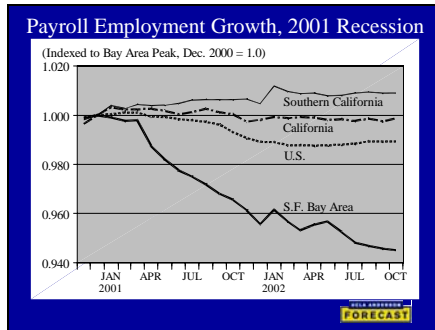
| | <u>2001</u> | <u>2002</u> | <u>2003</u> | <u>2004</u> |
|---|-------------|-------------|-------------|-------------|
| Employment (Nonfarm, % Change) | 1.4 | -0.2 | 0.7 | 2.2 |
| Personal Income (% Change) | 2.6 | 1.1 | 3.4 | 5.3 |
| Taxable Sales (% Change) | 0.0 | -3.3 | 4.1 | 6.1 |
| Building Permits (Residential, Thous.) | 149 | 161 | 167 | 165 |
| Unempl. Rate (Percent) | 5.3 | 6.4 | 6.7 | 6.4 |



Slide 5



Slide 6



Slide 7



Slide 8

Personal Income Taxes by Region

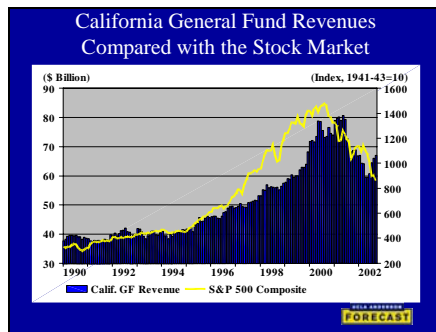
| | Tax Assessed (\$ million) | | | Percent Change | |
|---------------|---------------------------|--------|--------|----------------|---------|
| | 1996 | 1998 | 2000 | 1996-98 | 1998-00 |
| Bay Area | 6,477 | 8,588 | 17,573 | 32.6 | 104.6 |
| Southern Cal. | 10,535 | 13,306 | 17,027 | 26.3 | 28.0 |
| Other | 4,154 | 6,732 | 7,476 | 62.1 | 11.1 |
| State Total | 21,167 | 27,308 | 42,076 | 29.0 | 54.1 |

FORECAST

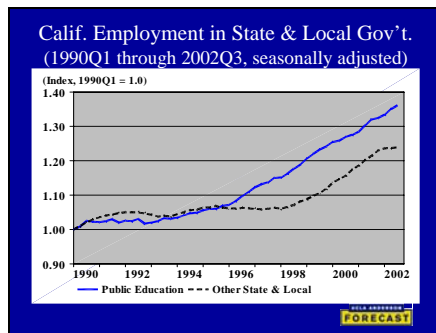
Slide 9



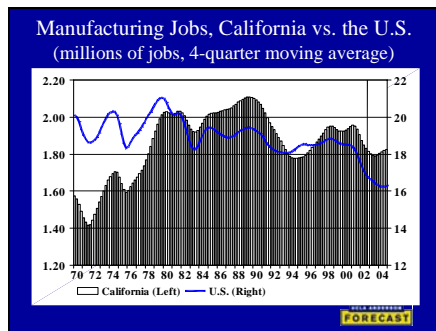
Slide 10



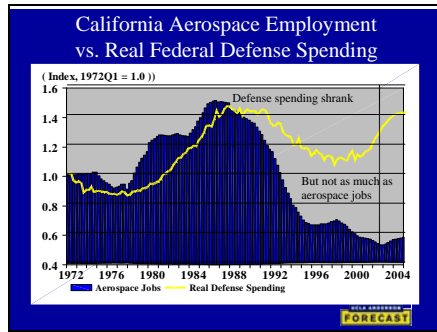
Slide 11



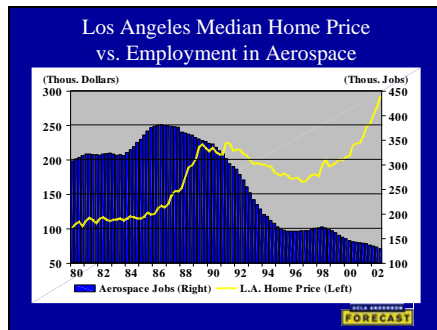
Slide 12



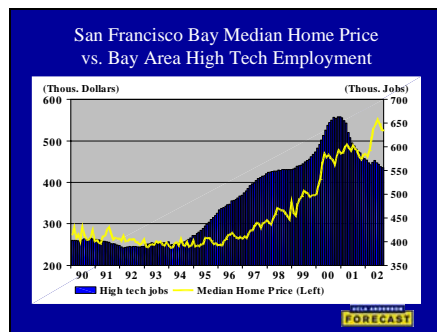
Slide 13



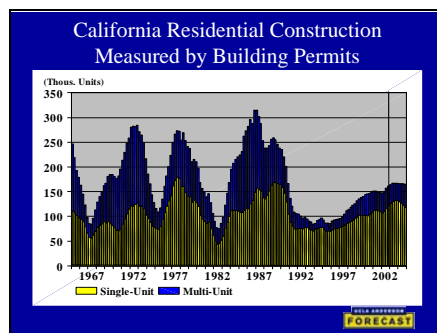
Slide 14



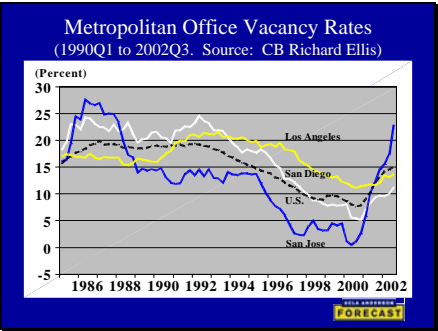
Slide 15



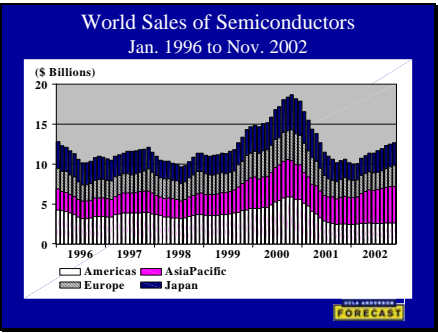
Slide 16



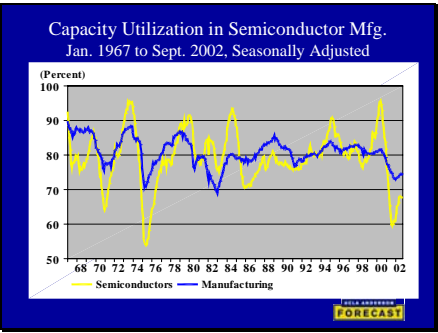
Slide 17



Slide 18



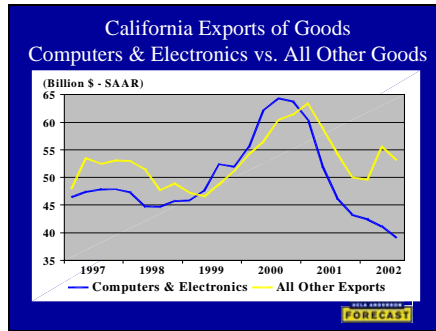
Slide 19



Slide 20



Slide 21



Slide 22

Summary of the UCLA Anderson
California Forecast

- ◆ California's downturn is nearing a bottom.
- ◆ Moderate expansion will begin in 2003 after a slow first half.
- ◆ Unemployment will increase to 6.7% in 2003.
- ◆ Improvement in the Bay Area will lag that in Southern California, paralleling the IT business.
- ◆ Home price increases will slow, home building will remain robust, nonresidential building will decline.

UCLA ANDERSON
FORECAST

From the offices of Assembly Members Dutra & Goldberg

Revenue Expected from Various Tax Rates on 25 Selected Services

| Number | Service | Estimated 2003-04 Receipts^ | Tax Rate | | | |
|--------------------------------------|--------------------------------------|-----------------------------------|----------|-------|-------|-------|
| | | | 6% | 5% | 3% | 1% |
| (all figures in millions of dollars) | | | | | | |
| 1 | Coin operated amusement machines | 116 | 7.0 | 5.8 | 3.5 | 1.2 |
| 2 | Sale of memberships to private clubs | 532 | 31.9 | 26.6 | 6.0 | 5.3 |
| 3 | Landscaping services | 1,318 | 79.1 | 65.9 | 39.5 | 13.2 |
| 4 | 900 number services | 129 | 7.7 | 6.5 | 3.9 | 1.3 |
| 5 | Telephone answering services | 393 | 23.6 | 19.7 | 11.8 | 3.9 |
| 6 | Marina service | 238 | 14.3 | 11.9 | 7.1 | 2.4 |
| 7 | Custom computer programs | 6,999 | 419.9 | 350.0 | 210.0 | 70.0 |
| 8 | Preliminary art services | 1,691 | 101.5 | 84.6 | 50.7 | 16.9 |
| 9 | Janitorial services | 3,075 | 184.5 | 153.8 | 92.3 | 30.8 |
| Sub-total | | 14,491 | 869.5 | 724.6 | 434.7 | 144.9 |

* Includes automobile washing, parking lots, storage and towing services.

^2003-04 receipts are based on estimated 2002-03 receipts

Page 2 of 2

Revenue Expected from Various Tax Rates on 25 Selected Services

| Service Sheet Number | | Estimated 2003-04 Receipts^ | Tax Rate | | | |
|--------------------------------------|--|-----------------------------------|----------|---------|---------|---------|
| | Service | | 6% | 5% | 3% | 1% |
| (all figures in millions of dollars) | | | | | | |
| 10 | Entertainment (admission charges) | 4,476 | 268.6 | 223.8 | 134.3 | 44.8 |
| 11 | Hotels / motels lodging | 10,134 | 608.0 | 506.7 | 304.0 | 101.3 |
| 12 | Cable TV | 5,420 | 325.2 | 271.0 | 162.6 | 54.2 |
| 13 | Satellite / DBS TV | 1,656 | 99.4 | 82.8 | 49.7 | 16.6 |
| 14 | Aircraft / limo charters | 915 | 54.9 | 45.8 | 27.5 | 9.2 |
| 15 | Moving - intra-state | 1,440 | 86.4 | 72.0 | 43.2 | 14.4 |
| 16 | Accounting and bookkeeping services | 15,561 | 933.7 | 778.1 | 466.8 | 155.6 |
| 17 | Legal services | 21,240 | 1,274.4 | 1,062.0 | 637.2 | 212.4 |
| 18 | Security and detective services | 3,833 | 230.0 | 191.7 | 115.0 | 38.3 |
| 19 | Linen and uniform services | 1,295 | 77.7 | 64.8 | 38.9 | 13.0 |
| 20 | Swimming pool services | 553 | 33.2 | 27.7 | 16.6 | 5.5 |
| 21 | Pager services | 862 | 51.7 | 43.1 | 25.9 | 8.6 |
| 22 | Cell phone services | 7,197 | 431.8 | 359.9 | 215.9 | 72.0 |
| 23 | Custom telephone services | 2,133 | 128.0 | 106.7 | 64.0 | 21.3 |
| 24 | Engineering, architectural & surveying services | 19,229 | 1,153.7 | 961.5 | 576.9 | 192.3 |
| 25 | Management, scientific & technical consulting services | 9,632 | 577.9 | 481.6 | 289.0 | 96.3 |
| Sub-total | | 105,576 | 6,334.6 | 5,278.8 | 3,167.3 | 1,055.8 |
| Grand Total | | 120,067 | 7,204.0 | 6,003.4 | 3,602.0 | 1,200.7 |

^2003-04 receipts are based on estimated 2002-03 receipts

NOTE: Services that are registered with the BOE are in **bold**

Revenue Expected from Various Tax Rates on 36 Selected Services

| Number | Service | Estimated 2003-04 Receipts^ | Tax Rate | | | |
|--------------------------------------|--|-----------------------------------|----------|---------|-------|-------|
| | | 6% | 5% | 3% | 1% | |
| (all figures in millions of dollars) | | | | | | |
| 1 | Coin operated amusement machines | 116 | 7.0 | 5.8 | 3.5 | 1.2 |
| 2 | Billiards / bowling facilities | 1,782 | 106.9 | 89.1 | 53.5 | 17.8 |
| 3 | Sale of memberships to private clubs | 532 | 31.9 | 26.6 | 6.0 | 5.3 |
| 4 | Health clubs, tanning booths & reducing salons | 273 | 13.7 | 13.7 | 8.2 | 2.7 |
| 5 | Laundry & dry cleaning services | 2,324 | 139.4 | 116.2 | 69.7 | 23.2 |
| 6 | Repair labor | 4,624 | 277.4 | 231.2 | 138.7 | 46.2 |
| 7 | Installation charges | 21 | 1.3 | 1.1 | 0.6 | 0.2 |
| 8 | Automotive services * | 2,908 | 174.5 | 145.4 | 87.2 | 29.1 |
| 9 | Landscaping services | 1,318 | 79.1 | 65.9 | 39.5 | 13.2 |
| 10 | Taxidermy services | 4 | 0.2 | 0.2 | 0.1 | 0.0 |
| 11 | Pet grooming services | 25 | 1.5 | 1.3 | 0.8 | 0.3 |
| 12 | Exterminating services | 1,015 | 60.9 | 50.8 | 30.5 | 10.2 |
| 13 | 900 number services | 129 | 7.7 | 6.5 | 3.9 | 1.3 |
| 14 | Telephone answering services | 393 | 23.6 | 19.7 | 11.8 | 3.9 |
| 15 | Marina service | 238 | 14.3 | 11.9 | 7.1 | 2.4 |
| 16 | Preliminary art services | 1,691 | 101.5 | 84.6 | 50.7 | 16.9 |
| 17 | Custom computer programs | 6,999 | 419.9 | 350.0 | 210.0 | 70.0 |
| 18 | Funeral services | 491 | 29.5 | 24.6 | 14.7 | 4.9 |
| 19 | Janitorial services | 3,075 | 184.5 | 153.8 | 92.3 | 30.8 |
| Sub-total | | 27,958 | 1,677.5 | 1,397.9 | 838.7 | 279.6 |

* Includes automobile washing, parking lots, storage and towing services.

[^]2003-04 receipts are based on estimated 2002-03 receipts

Page 2 of 2

Revenue Expected from Various Tax Rates on 36 Selected Services

| Service Sheet Number | Service | Estimated 2003-04 Receipts^ | Tax Rate | | | |
|--------------------------------------|--|-----------------------------------|----------|---------|---------|---------|
| | | | 6% | 5% | 3% | 1% |
| (all figures in millions of dollars) | | | | | | |
| 20 | Entertainment (admission charges) | 4,476 | 268.6 | 223.8 | 134.3 | 44.8 |
| 21 | Hotels / motels lodging | 10,134 | 608.0 | 506.7 | 304.0 | 101.3 |
| 22 | Cable TV | 5,420 | 325.2 | 271.0 | 162.6 | 54.2 |
| 23 | Satellite / DBS TV | 1,656 | 99.4 | 82.8 | 49.7 | 16.6 |
| 24 | Aircraft / limo charters | 915 | 54.9 | 45.8 | 27.5 | 9.2 |
| 25 | Moving - intra-state | 1,440 | 86.4 | 72.0 | 43.2 | 14.4 |
| 26 | Automotive repair services | 4,228 | 253.7 | 211.4 | 126.8 | 42.3 |
| 27 | Accounting and bookkeeping services | 15,561 | 933.7 | 778.1 | 466.8 | 155.6 |
| 28 | Legal services | 21,240 | 1,274.4 | 1,062.0 | 637.2 | 212.4 |
| 29 | Security and detective services | 3,833 | 230.0 | 191.7 | 115.0 | 38.3 |
| 30 | Linen and uniform services | 1,295 | 77.7 | 64.8 | 38.9 | 13.0 |
| 31 | Swimming pool services | 553 | 33.2 | 27.7 | 16.6 | 5.5 |
| 32 | Pager services | 862 | 51.7 | 43.1 | 25.9 | 8.6 |
| 33 | Cell phone services | 7,197 | 431.8 | 359.9 | 215.9 | 72.0 |
| 34 | Custom telephone services | 2,133 | 128.0 | 106.7 | 64.0 | 21.3 |
| 35 | Engineering, architectural & surveying services | 19,229 | 1,153.7 | 961.5 | 576.9 | 192.3 |
| 36 | Management, scientific & technical consulting services | 9,632 | 577.9 | 481.6 | 289.0 | 96.3 |
| Sub-total | | 109,804 | 6,588.2 | 5,490.2 | 3,294.1 | 1,098.0 |
| Grand Total | | 137,762 | 8,265.7 | 6,888.1 | 4,132.9 | 1,377.6 |

[^]2003-04 receipts are based on estimated 2002-03 receipts

State Sales and Use Tax (SUT) Breakdown

Components of the Statewide 7.25% Sales and Use Tax Rate

| Rate | Jurisdiction | R&T Code |
|--------------|--|---|
| 4.75% | State (General Fund) | 6051, 6201 |
| 0.50% | State (Local Revenue Fund) | 6051.2, 6201.2 |
| 0.25% | State (General Fund) | 6051.3, 6201.3 (<i>inoperative 1/1/01 - 12/31/01</i>) |
| 0.50% | State (Local Public Safety Fund) | Section 35 Article XIII State Constitution |
| 1.25% | Local (City and County) 1.00% City and County Operations 0.25% County transportation funds | 7202 (a), 7203 |
| 7.25% | Total Statewide Base Sales and Use Tax (SUT) | |

This breakdown applies to ALL cities and counties; however, some counties, as well as some cities within certain counties, have additional sales taxes (or district taxes) which they use for other purposes. The total sales tax for each county is listed below:

| | | |
|--------------------|----------------------|-----------------------|
| Alameda 8.25% | Madera 7.75% | San Joaquin 7.75% |
| Alpine 7.25% | Marin 7.25% | San Luis Obispo 7.25% |
| Amador 7.25% | Mariposa 7.75% | San Mateo 8.25% |
| Butte 7.25% | Mendocino 7.25% | Santa Barbara 7.75% |
| Calaveras 7.25% | Merced 7.25% | Santa Clara 8.25% |
| Colusa 7.25% | Modoc 7.25% | Santa Cruz 8.00% |
| Contra Costa 8.25% | Mono 7.25% | Shasta 7.25% |
| Del Norte 7.25% | Monterey 7.25% | Sierra 7.25% |
| El Dorado* 7.25% | Napa 7.75% | Siskiyou 7.25% |
| Fresno* 7.875% | Nevada* 7.375% | Solano 7.375% |
| Glenn 7.25% | Orange 7.75% | Sonoma 7.50% |
| Humboldt 7.25% | Placer 7.25% | Stanislaus 7.375% |
| Imperial* 7.75% | Plumas 7.25% | Sutter 7.25% |
| Inyo 7.75% | Riverside 7.75% | Tehama 7.25% |
| Kern 7.25% | Sacramento 7.75% | Trinity 7.25% |
| Kings 7.25% | San Benito 7.25% | Tulare 7.25% |
| Lake* 7.25% | San Bernardino 7.75% | Tuolumne 7.25% |
| Lassen 7.25% | San Diego 7.75% | Ventura 7.25% |
| Los Angeles* 8.25% | San Francisco 8.50% | Yolo* 7.25% |
| | | Yuba 7.25% |

* The following district taxes are imposed in cities and not throughout an entire county. These district taxes, alone or when combined with county-wide district taxes, create a higher total tax rate in some areas of a county.

| County | District Name | District Boundary | Total Tax Rate |
|---------------|--|----------------------------|-----------------------|
| El Dorado | City of Placerville Public Safety Transactions and Use Tax | City Limits of Placerville | 7.50% |
| Fresno | City of Clovis Public Safety Transactions and Use Tax | City limits of Clovis | 8.175% |
| Imperial | Calexico Heffernan Hospital District | City limits of Calexico | 8.25% |
| Lake | City of Clearlake Public Safety Transactions and Use Tax | City limits of Clearlake | 7.75% |
| Los Angeles | City of Avalon Municipal Hospital and Clinic Tax | City limits of Avalon | 8.75% |
| Nevada | Town of Truckee Road Maintenance Transactions and Use Tax | Town limits of Truckee | 7.875% |
| Yolo | City of Woodland General Revenue Transactions and Use Tax | City limits of Woodland | 7.75% |

Listed below is the breakdown of how the additional sales tax in those counties, and specific cities, with higher rates than 7.25% are used:

| Tax Area | District Name | Rate | Effective Date | End Date |
|------------------------------------|---|-------------|-----------------------|-----------------|
| Alameda County | Alameda County Transportation Improvement Authority (ACTI) | 0.50% | 04-01-02 | |
| | Alameda County Transportation Authority (ACTA) | 0.50% | 04-01-87 | 03-31-02 |
| | Bay Area Rapid Transit District (BART) | 0.50% | 04-01-70 | |
| Contra Costa County | Contra Costa Transportation Authority (CCTA) | 0.50% | 04-01-89 | |
| | Bay Area Rapid Transit District (BART) | 0.50% | 04-01-70 | |
| Del Norte County | Del Norte County District (DNCD) | 0.50% | 07-01-93 | 06-30-98 |
| El Dorado County | City of Placerville Public Safety Transactions (In City of Placerville only) and Use Tax (PLPS) | 0.25% | 04-01-99 | |
| Clovis (City) | City of Clovis Public Safety Transactions and Use Tax (CCPS) | 0.30% | 04-01-00 1 | |
| Fresno County | Fresno County Public Library Transactions and Use Tax (FCPL) | 0.125% | 04-01-99 | |
| Fresno (City) | Fresno Metropolitan Projects Authority (FMPA) | 0.10% | 07-01-93 | 03-20-96 |
| Fresno County | Fresno County Transportation Authority (FCTA) | 0.50% | 07-01-87 | |
| Calexico (City) Imperial County | Calexico Heffernan Memorial Hospital District (CXHD) | 0.50% | 10-01-92 2 | |
| | Imperial County Local Transportation Authority (IMTA) | 0.50% | 04-01-90 | |
| Inyo County | Inyo County Rural Counties Transactions Tax (INRC) | 0.50% | 10-01-88 | |
| Lake County | City of Clearlake Public Safety Transactions and Use | 0.50% | 07-01-95 | |

| | | | | |
|--|--|--------|----------|----------|
| (in City of Clearlake only) Tax (CLPS) | | | | |
| Avalon (City) | City of Avalon Municipal Hospital and Clinic Tax (AMHC) | 0.50% | 10-01-00 | 3 |
| Los Angeles County | Los Angeles County Transportation Commission (LATC) | 0.50% | 04-01-91 | |
| | Los Angeles County Transportation Commission (LACT) | 0.50% | 07-01-82 | |
| Madera County | Madera County Transportation Authority (MCTA) | 0.50% | 10-01-90 | |
| Mariposa County | Mariposa County Healthcare Authority (MCHA) | 0.50% | 07-01-00 | |
| Monterey | Monterey County Public Repair and Improvement Authority (MPRI) | 0.50% | 04-01-90 | 09-30-92 |
| Napa County | Napa County Flood Protection Authority Tax (NCFP) | 0.50% | 07-01-98 | |
| Truckee (City) | Town of Truckee Road Maintenance Transactions and Use Tax (TRSR) | 0.50% | 10-01-98 | 4 |
| Nevada County | Nevada County Public Library Transactions and Use Tax (NVPL) | 0.125% | 10-01-98 | |
| Orange County | Orange County Local Transportation Authority (OCTA) | 0.50% | 04-01-91 | |
| Riverside County | Riverside County Transportation Commission (RCTC) | 0.50% | 07-01-89 | |
| Sacramento County | Sacramento Transportation Authority (STAT) | 0.50% | 04-01-89 | |
| San Benito County | San Benito County General Fund Augmentation (SBTU) | 0.50% | 01-01-94 | 12-31-97 |
| | San Benito County Council of Governments (SBCG) | 0.50% | 01-01-89 | 12-31-98 |
| San Bernardino County | San Bernardino County Transportation Authority (SBER) | 0.50% | 04-01-90 | |
| San Diego County | San Diego County Regional Justice Facility (SDJF) | 0.50% | 01-01-89 | 02-13-93 |
| | San Diego County Regional Transportation Commission (SDTC) | 0.50% | 04-01-88 | |
| San Francisco City and County | San Francisco County Public Finance Authority (SFPF) | 0.25% | 10-01-93 | |
| | San Francisco Educational Finance Authority (SFEA) | 0.25% | 02-01-92 | 06-30-93 |
| | San Francisco County Transportation Authority (SFTA) | 0.50% | 04-01-90 | |
| | Bay Area Rapid Transit District (BART) | 0.50% | 04-01-70 | |
| San Joaquin County | San Joaquin Transportation Authority (SJTA) | 0.50% | 04-01-91 | |
| San Mateo County | San Mateo County Transportation Authority (SMTA) | 0.50% | 01-01-89 | |
| | San Mateo County Transit District (SMCT) | 0.50% | 07-01-82 | |
| Santa Barbara County | Santa Barbara County Local Transportation Authority (SBAB) | 0.50% | 04-01-90 | |
| Santa Clara County | Santa Clara County Transactions and Use Tax (SCGF) | 0.50% | 04-01-97 | |
| | Santa Clara County Traffic Authority (SCTC) | 0.50% | 04-01-85 | 03-31-95 |
| | Santa Clara County Transit District (SCCT) | 0.50% | 10-01-76 | |
| Santa Cruz County | Santa Cruz County Public Library Transactions and Use Tax (SZPL) | 0.25% | 04-01-97 | |

| | | | | |
|-------------------|--|--------|----------|----------|
| | Santa Cruz County Earthquake Recovery Bond (SCER) | 0.50% | 04-01-91 | 03-31-97 |
| | Santa Cruz Metropolitan Transit District (SCMT) | 0.50% | 01-01-79 | |
| Solano County | Solano County Public Library Transactions and Use Tax (SLPL) | 0.125% | 10-01-98 | |
| Sonoma County | Sonoma County Open Space Authority (SCOS) | 0.25% | 04-01-91 | |
| Stanislaus County | Stanislaus County Library Transactions and Use Tax (STCL) | 0.125% | 07-01-95 | |
| Tulare County | Tulare County Transactions and Use Tax (TCTU) | 0.50% | 10-01-95 | 12-31-97 |
| Yolo County | City of Woodland General Revenue (In city of Woodland only) Transactions and Use Tax (WOGT) | 0.50% | 07-01-00 | 5 |

1. For sales made within the city limits of Clovis (in addition to Fresno County district taxes).
2. For sales made within the city limits of Calexico (in addition to Imperial County district taxes).
3. For sales made within the city limits of Avalon (in addition to Los Angeles County district taxes).
4. For sales made within the city limits of the Town of Truckee (in addition to Nevada County district taxes).
5. For sales made within the city limits of Woodland.

Source: Board of Equalization, *California City and County Sales and Use Tax Rates*, April 2002.

| 2002-2003 Mid Year and 2003-2004 Budget Revenue Enhancement Proposals January 16, 2003 | 2003-2004 REVENUE GAIN (\$Thousands) | | | |
|--|---|-------------|-------------|-------------|
| | (a) | (b) | (c) | (d) |
| Personal Income Tax (PIT) | | | | |
| Reinstate upper tax bracket (10% and 11%) | \$2,580,000 | | | |
| 2% Surcharges on existing income tax liabilities | \$1,000,000 | | | |
| 5% Surcharges on existing income tax liabilities | \$2,500,000 | | | |
| Bank and Corporate Tax (BCT) | | | | |
| Partially or fully restore franchise tax from 8.84% to (a) 8.955% (b) 9.07% (c) 9.185% or (d) 9.30 and accordingly adjust 6.65% AMT rate | \$65,000 | \$125,000 | \$195,000 | \$260,000 |
| Restore "S" Corporation rate from 1.5% to (a) 2.0% or (b) 2.5% | \$230,000 | \$460,000 | | |
| Increase minimum franchise tax from \$800 to (a) \$825 (b) \$850 (c) \$875 or (d) \$900 | \$12,000 | \$23,000 | \$38,000 | \$49,000 |
| Oil Industry Credits and Allowances¹ | | | | |
| Eliminate percentage depletion allowance | \$28,000 | | | |
| Eliminate manufacturer's investment credit for oil refineries | \$40,000 | | | |
| Eliminate intangible drilling allowances | \$10,000 | | | |
| Sales and Use Tax (SUT) | | | | |
| Statewide Sales Tax Increase (a) .25% (b) .5% (c) .75% or (d) 1% | \$1,208,000 | \$2,416,000 | \$3,624,000 | \$4,832,000 |

¹ Based on estimates for 2002-2003

| | | | | |
|--|-------------|-------------|-------------|-------------|
| E- Commerce | | | | |
| Extension of the Sales Tax to Services² | | | | |
| 25 selected services @ (a) 1% (b) 35 (c) 55 or (d) 1% | \$1,200,700 | \$3,602,000 | \$6,003,400 | \$7,204,000 |
| 36 selected services @ (a) 1% (b) 35 (c) 55 or (d) 1% | \$1,377,600 | \$4,132,900 | \$6,888,100 | \$8,265,700 |
| Property Taxes³ | | | | |
| Split Roll (Commercial, Non-residential) | | | | |
| Alcoholic Beverage Taxes | | | | |
| Increase tax per gallon for beer from 20 cents to (a) 25 cents (b) 30 cents (c) 35 cents or (d) 40 cents | \$33,300 | \$66,600 | \$99,900 | \$133,200 |
| Increase tax per gallon for most wines from 20 cents to (a) 25 cents (b) 35 cents (c) 45 cents or (d) 60 cents | \$5,200 | \$15,700 | \$24,500 | \$41,800 |
| Increase tax per gallon for champagne or sparkling wine from 30 cents to (a) 35 cents (b) 45 cents (c) 55 cents or (d) 60 cents | \$300 | \$900 | \$1,500 | \$1,800 |
| Increase tax per gallon on distilled spirits 100 proof or less form \$3.30 to (a) \$3.63 (b) \$3.80 (c) \$3.96 or (d) \$4.95 | \$14,100 | \$21,300 | \$28,200 | \$70,400 |
| Increase tax per gallon on distilled spirits over 100 proof or less form \$6.60 to (a) \$7.26 (b) \$7.59 (c) \$7.92 or (d)\$9.90 | \$125 | \$188 | \$251 | \$627 |

² See List

³ Will not produce revenue until 2004-2005 fiscal year

| 2002-2003 Mid Year and 2003-2004 Budget Revenue Enhancement Proposals January 16, 2003 | 2003-2004 REVENUE GAIN (\$Thousands) | | | |
|--|---|-----------|-------------|-------------|
| | (a) | (b) | (c) | (d) |
| Cigarette and Tobacco Taxes | | | | |
| Increase tax per pack from \$0.87 to: a) \$1.27 b) \$1.47 c) \$1.67 or d) \$1.97 | \$437,500 | \$639,600 | \$830,700 | \$1,170,000 |
| Gambling Revenues⁴ | \$1,500,000 | | | |
| Vehicle License Fee (VLF) | | | | |
| Fully Reinstate VLF to 2% | \$3,940,000 | | | |
| Fully Reinstate VLF to 2% while maintaining full 67.5% reduction for vehicles @ \$10K or less | \$3,427,000 | | | |
| Reinstate VLF to 1999 level 1.5% | \$2,552,000 | | | |
| Reinstate VLF to 2000 level of 1.3% | \$1,951,000 | | | |
| Governor's VLF backfill shift from state to local governments | \$2,930,000 | | | |
| Transfer Tax⁵ | | | | |
| Transfer Tax of (a) .25% (b) .5% (c) .75% or (d) 1.0% on the sale or transfer of all commercial and urban agricultural real property whether or not improved. Exempting, therefore, only residential real property whether or not improved. Real Properties used or designated for transient use as hotels or motels in the normal course of business having occupancies or 30 days or less, whether or not improved, shall be subject to transfer tax | \$400,000 | \$800,000 | \$1,200,000 | \$1,600,000 |
| Transient Occupancy Tax (TOT) | | | | |
| Lodging (Motel & Hotel) (a) .505 (b) .75% (c) 1.0 % (d) 1.25% | \$52,000 | \$78,000 | \$104,000 | \$130,000 |

⁴ Dependent upon Indian gaming compacts, no legislation required.

⁵ Requires constitutional amendment